CANADIAN NATIONAL

ANNUAL REPORT 1987

92-04935/

COVER NOTE

Montreal artist Pim Sekeris is responsible for the cover painting and nine others inside. All are related to CN's railway transportation business which accounts for almost 80 per cent of total revenues. Beginning on page six and continuing on the seven following spreads are paintings symbolizing the individual units responsible for particular groups of freight commodities, and which are in the forefront of CN's drive toward customer orientation. The final painting on page 22 summarizes the intensive planning and development process that has gone on throughout 1987 to prepare CN for the challenges ahead.

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La version française du présent rapport est disponible sur demande à l'adresse suivante:

Canadien National
Affaires publiques et Publicité
C.P. 8100, Montréal (Québec)
H3C 3N4

SYSTEM HIGHLIGHTS

Five Year Financial and Statistical Summary

($ millions unless otherwise indicated)	1987	1986	1985	1984	1983
Operations					
Revenues	$ 4,784.1	$ 4,874.5	$ 5,017.8	$ 4,987.5	$ 4,659.3
Operating income	$ 487.4	$ 279.4	$ 440.0	$ 552.9	$ 465.4
Interest expense – net	$ 371.9	$ 382.3	$ 336.2	$ 349.1	$ 268.4
Net income (loss)	$ 120.6	$ (86.3)	$ 117.6	$ 242.0	$ 212.3
Dividend	$ 24.1	$ –	$ 23.5	$ 48.4	$ 42.5
Return on average investment %	7.9	4.6	7.2	9.2	9.1
Return on average equity %	4.0	–	3.5	7.5	7.1
Capital Expenditures					
Property and equipment	$ 482.1	$ 484.1	$ 744.5	$ 713.1	$ 714.4
Assets and Working Capital					
Current assets	$ 965.8	$ 1,124.6	$ 1,128.0	$ 1,019.9	$ 1,035.2
Working capital deficiency	$ 485.4	$ 373.6	$ 358.6	$ 266.7	$ 32.0
Properties	$ 6,212.5	$ 6,248.5	$ 6,193.5	$ 5,771.0	$ 5,612.2
Total assets	$ 7,593.6	$ 7,842.6	$ 8,138.8	$ 7,466.6	$ 6,789.7
Capital Structure					
Long-term debt (including current portion)	$ 2,936.9	$ 3,358.3	$ 3,172.2	$ 2,692.4	$ 2,357.8
Equity	$ 3,101.1	$ 3,004.6	$ 3,418.5	$ 3,324.3	$ 3,112.6
Debt ratio %	48.6	52.8	48.1	44.7	43.1
Traffic					
Revenue ton miles freight (billions)	101.7	94.2	91.6	97.4	86.7
Employees					
Average number for year	50,862	56,715	61,124	66,234	63,496
Average annual wage per employee	$ 36,706	$ 35,680	$ 34,484	$ 32,905	$ 30,767
Average annual cost per employee	$ 46,218	$ 43,897	$ 41,016	$ 39,339	$ 36,385
Expenditures in Canada					
Purchases	$ 895.0	$ 1,034.0	$ 1,232.0	$ 1,295.0	$ 1,098.0
Wages, salaries and fringe benefits	$ 1,969.8	$ 2,064.1	$ 2,070.0	$ 2,212.9	$ 2,002.5
Taxes	$ 351.7	$ 367.3	$ 347.0	$ 343.5	$ 300.9

The Honourable John Crosbie,
Minister of Transport.

Dear Mr. Minister:

On behalf of the Board of Directors and in accordance with provisions of the Railway Act, I am pleased to submit Canadian National's annual report for the year ending December 31st, 1987.

I look back on the past year with considerable satisfaction. During that time, it has been my privilege to become acquainted with many of the people who serve this great Canadian Crown corporation. The remarkable turnaround in net income recorded in this report is to their credit, and to that of their colleagues.

Their skill and dedication will, I believe, enable the company to meet the challenging goals it has set for itself. The ultimate objective is to provide the competitive transportation and distribution services needed by Canadian business and industry. In pursuing its commercial mandate, CN will serve Canada best.

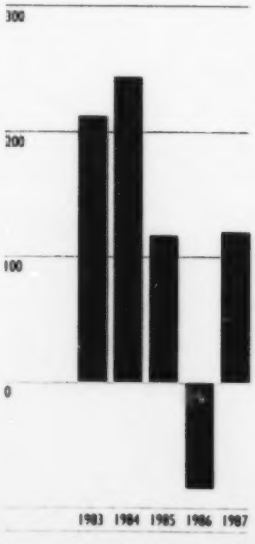
Brian Gallery
Acting Chairman

1987 saw full operation of the new Customer Service Centre in Toronto. The centre comprises the sophisticated technology and the skilled personnel needed to improve customer contact and response time in a market-driven company.

PRESIDENT AND CHIEF EXECUTIVE OFFICER'S STATEMENT

CN NET INCOME

In millions of dollars



A COMPANY ON THE MOVE

Canadian National is a company in motion – a company which anticipated many of the economic, social and technological patterns of recent years and is well advanced in the difficult process of adjusting and adapting to them.

In the pages which follow, the procedures, plans and activities enabling the company to compete effectively in the evolving national and international transportation marketplace are described in detail. Two themes are constant:

- Customers remain the cornerstone of Canadian National's rail product; they are our reason for being in business and the final judges of our services.
- CN's future success depends on its ability to meet the formidable challenges of today's competitive economic environment.

In 1987, significant productivity-related achievements were recorded in:

- Network and terminal rationalization: the company prepared for an increased rate of line abandonments and completed a number of terminal facility reductions and eliminations in all parts of the country.
- The application of new technology: major systems were introduced or placed under test to enhance internal information flow and CN/customer interface. In addition, high-tech equipment was installed to increase safety, modernize shop procedures, improve maintenance of way performance, and better control train operations.
- Administrative restructuring: an important study by Booz.Allen & Hamilton Inc., a leading North American transportation consulting firm, was completed. Several of its recommendations became the subject of task force action in 1987, with implementation planned for 1988. These recommendations include a strengthened approach to marketing, building on the line-of-business segments, and a pilot productivity improvement project in the Great Lakes Region operating function. Both are designed to equip CN for the new competitive environment the company faces.

Other, related efforts were also pursued:

- The infusion of capital to improve efficiency and service in our fastest-growing market segment, the intermodal transportation of goods.
- The divestiture of CN Hotels as a means of reducing corporate debt.
- Continuing efforts to reduce the company's labor costs in a fair and responsible manner.

Productivity gains helped achieve a sizeable reduction in operating costs in 1987. With freight tonnage up 6.2 per cent, net income rose to $120.6 million, a turnaround of $206.9 million from 1986.

As good as it is, net income of that level cannot ensure CN's long-term viability. The cost of debt servicing, and the never-ending requirement to renew physical plant and equipment, call for well more than double the 1987 level of net income.

A new transportation act, which went into effect January 1, 1988, and the prospect of freer trade with the United States, lend additional urgency to the need for more adaptation and change. In imposing more rigorous commercial criteria in the transportation marketplace, and in expanding both competition and opportunities, these developments are changing forever the role railways play in Canada.

Canadian National welcomes the challenge of providing Canadian shippers with an effective and efficient transportation service to enable them to compete in Canada and internationally. The company also takes pride in running one of the most important railways in the world and intends to do what is necessary to ensure that this remains so.

The company has operated within a competitive commercial environment throughout its history, but the pressures for creative approaches and more effective responses to the marketplace have never been more intense.

The company brings impressive strengths to this environment: a focused market orientation, profitability, and competitiveness. These strengths are rooted in a strong customer base, an excellent physical plant, an imposing record of technological innovation and productivity gains, an effective research and development component, a reputation for conscientiousness, a forward-thinking management, and a dedicated staff. Looking to the challenges ahead, CN has developed an aggressive new market strategy based on innovative customer services, appropriate market niches, and varied modes and combinations of transportation and related systems to deliver goods.

CN employees understand the extent and seriousness of the challenge before us. Each of us is proud of the company and conscious of the role we can play in completing the task of strengthening Canadian National for the competitive realities of the future.

The quality of decisions made today will largely determine the quality of our future. Canadian National's tomorrow, then, is promising indeed, because it has been planned for carefully, thoughtfully, and on a solid foundation.

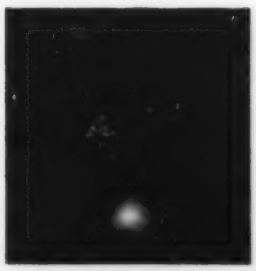
Ronald E. Lawless

THE ENVIRONMENT

IN WHICH CN

MUST FUNCTION

The second half of the 20th Century will be remembered as the period in which relentless, accelerating change became a permanent factor in human affairs. Change has been a characteristic of Canadian National's environment since the company's inception. But rapid technological development, and rising production of and demand for goods and services among developed and newly industrialized nations, have altered the nature of the economic environment on a global scale.



Today, there is unprecedented complexity in economic affairs, accompanied by much greater interdependence among nations and rapidly evolving trading patterns. As global competition for export markets intensifies, producers will be expected to offer more value-added goods and services to increasingly discriminating buyers.

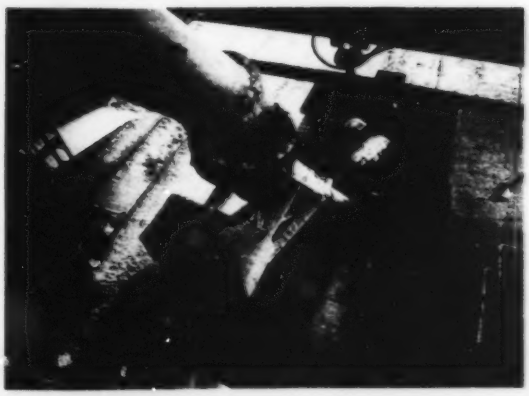
In this environment, any Canadian company that wants to prosper will have to accept one fact of life: the world economy leads. Market strategies will succeed only if they reflect Canada's international position.

For CN, the message is both clear and simple: many decisions which affect the company's volume of business will be made outside Canada's border. In a world context, the Canadian marketplace is small. Although Canadian National must not neglect its obligations as a large and important player in this small market, the company cannot permit itself to lose sight of world markets, of world product mandates and world-wide competition. To protect its interests and to capitalize on the opportunities surfacing, the corporation must continue to:

- Be aggressive in maintaining its existing customer base while meeting the service requirements and opportunities of the new world marketplace;
- Be assured of the management expertise needed to operate successfully in light of the new competitive environment;
- Be a leader in developing, adapting and making use of new technology;
- Be free and willing to pursue a global marketing strategy through exploitation of its world-class transportation, communication and information technologies;
- Be able to keep informed about world trends in economics, business, and transportation through the maintenance and expansion of its internal knowledge base.

Even though managing the corporation has become more complex and demanding, Canadian National has been responding well to the tempo of the times.

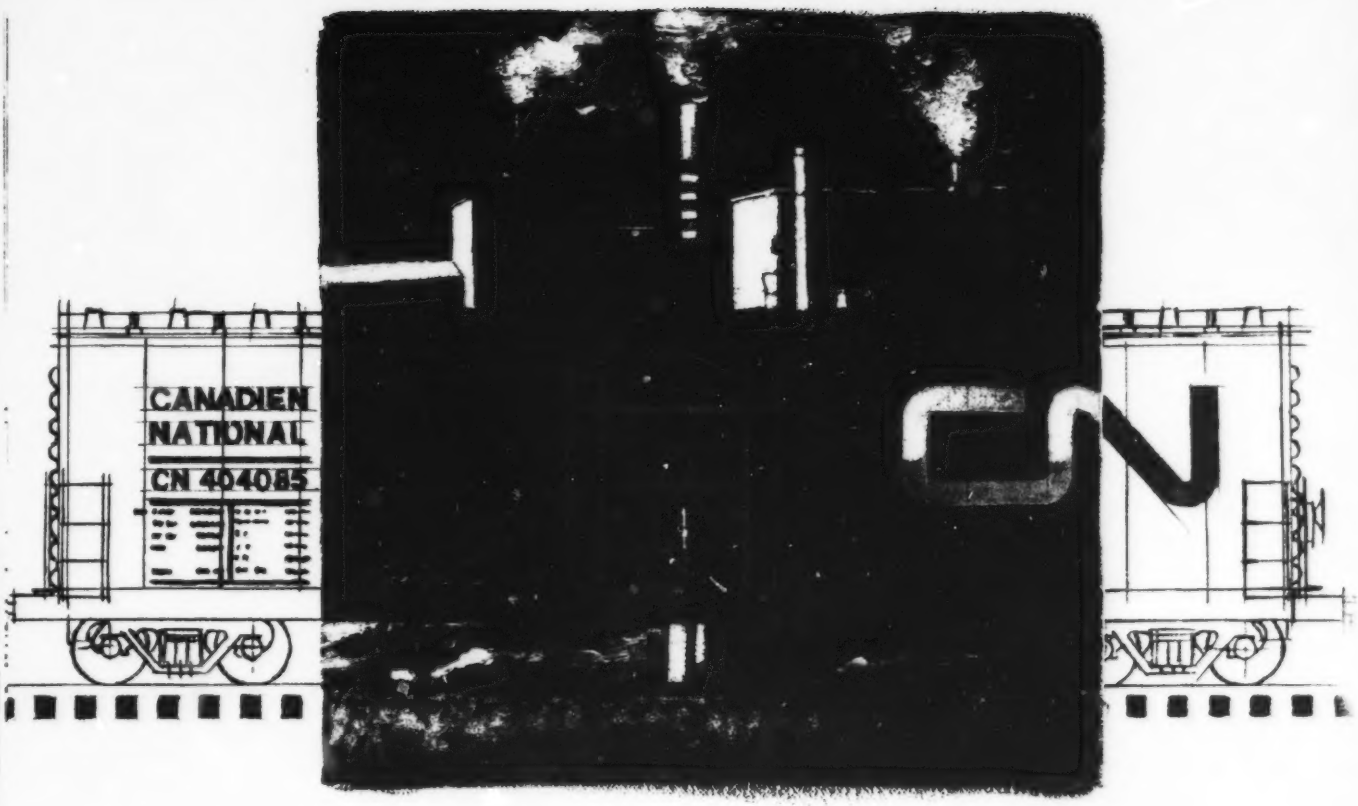
One example is the company's response to the collapse of commodity prices in the world's natural resource markets. By 1986, commodity prices had dropped to the low of the Great Depression. The world was awash in grain, coal, ores, minerals and metals. A number of Canadian industries, including the railways, found their positions threatened because they had relied on the resource sector as a major source of growth.



One of CN's largest commodity groups, coal, sulphur and potash, is concentrated in Western Canada. CN transports these bulk commodities direct to North American markets and to ports at Thunder Bay, Prince Rupert and Vancouver for shipment overseas. The painting at left depicts a coal hopper car at an Alberta loading facility. On this page, potash is seen being loaded in Saskatchewan, and a sulphur train moves through the Rockies towards Vancouver.

CN reacted by holding the line on operating expenditure and capital investment, maintaining its ability to meet the existing demands while remaining prepared to reduce or expand service capacity as the situation developed.

CN continues to respond effectively to the challenge of new economic forces and circumstances. Although, as a look at the balance sheet demonstrates, the company is not out of the woods, it has clearly found the path.



NEW STRATEGIES

FOR CHANGING MARKETS

Canada and its railways grew up together. In the early days, railways promoted the settlement and industrial development of Canada's far-flung regions, playing an important role in the building of a nation.
Times have changed and Canada has matured. Its railways have also changed, and continue to evolve along with Canadians' needs.

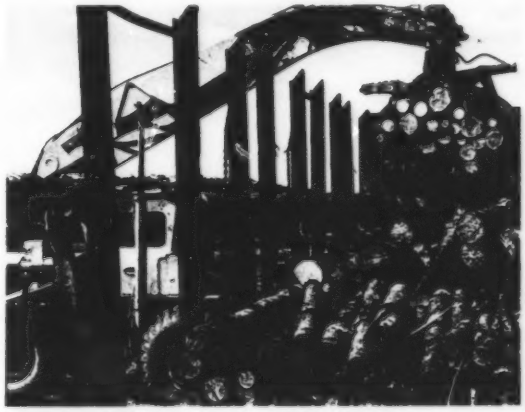
Canada's railways are no longer expected to fulfill a nation-building mandate, but rather to play a supporting role: serving Canada's industries in their quest for a larger share of markets at home and abroad.

However, Canadian railways can only perform that role if they remain financially viable – if they can reconcile the demand for reasonably priced transportation services with the requirement to remain financially healthy. This is the basis of CN's new market strategy.

The new strategy calls for careful analysis of customer needs, identification of areas in which CN can enhance the competitiveness of its customers, and imaginative design of services involving cost savings for customers while ensuring an adequate profit margin.

Over the past year, CN has laid the groundwork for this strategy by implementing organizational and service-specific measures, including:

- Strengthening of the marketing organization along product lines, with greater responsibility and a higher profile for individual product sector managers.
- Creation of a new business unit for the pulp and paper industry to focus on opportunities in this important sector.
- Development of specific service packages to meet customer needs effectively. Examples range from a new method of handling automobiles for the Newfoundland market, through institution of variable rates to promote more efficient use of the grain distribution system, to developing multimodal systems for dock-to-dock handling of potatoes.



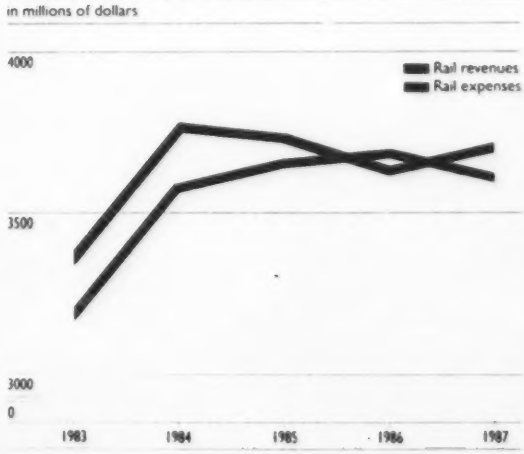
Newsprint has long been a top-priority commodity for CN. Customer-oriented strategies have ensured CN a strong position in this market. The painting top left portrays the high-quality freight car assigned to this service, against a backdrop of a modern paper mill. Photos show pulpwood being loaded, on its way to becoming newsprint, and a CN account executive with the finishing and shipping superintendent of a Quebec paper mill.

- Planning for a customer awareness program intended to imbue all employees with the competitive spirit essential to enhancing CN's position in the transportation marketplace.
- Implementation of customer information and monitoring systems – a family of customer-oriented computer information systems designed to give shippers up-to-the-minute status reports on the movement of their goods.

But railways are only one player in the distribution game. During 1987, the Roads and Transportation Association of Canada put forward a proposal for increased truck weights and dimensions on the nation's highways.

CN believes that the RTAC recommendations, if implemented, could lead to a major diversion of rail traffic to the highway mode and might drive some railway routes and services below the break-even point. In February 1988, the Council of Transport Ministers responsible for transportation and highway safety agreed to hold trailer lengths to existing sizes, with some exceptions, and to study the issue further. CN opposed the proposals in 1987 and will continue to do so.

RAIL REVENUES COMPARED TO RAIL EXPENSES



NEW SERVICE PATTERNS

IN RESPONSE

TO NEW NEEDS

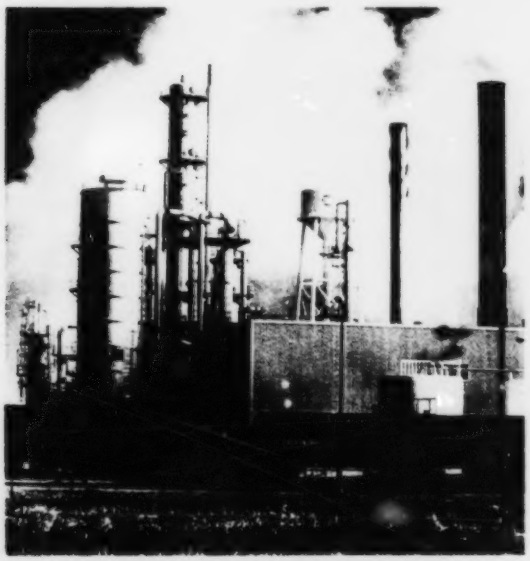
Development of the highway system in the post-war era, together with other, more recent events, has accelerated the demise of a Canada dependent on its railways, and its railways dependent on their role as a universal transporter. These events include the prospect of freer trade with the United States, the relative decline in Canada's trade as other countries (particularly Pacific Rim nations) experience extraordinary growth, and regulatory reform of all modes of transportation in Canada.

For CN, these developments dictated a significant redesign in 1987 of the services offered to shippers, a concentration of marketing efforts in areas where the company could meet a real need.

To meet the needs of today's shippers, CN envisages a railway system with these features:

- Concentration on main-line operations – lines which generate enough traffic to pay their own way and justify further investment.
- Strategically located distribution centres permitting bulk rail shipments to be distributed locally by truck.
- A network of local distribution services, using CN's own intermodal operation, or trucking firms under contract to the railway, for direct delivery.
- Expanded services into the United States in anticipation of greater transborder traffic.
- Improved information flow from off-shore centres to better deploy CN's resources.
- More short-line and regional railway systems (legislation permitting) feeding traffic to CN's main-line network under co-operative arrangements.

During 1987, CN made a number of key moves to establish itself in the new transportation marketplace. Some are based on a belief that intermodal systems – the strategic combination of a number of modes, making the best use of the strengths of each – represent the way of the future. Others were made in anticipation of greater Canada-U.S. trade and Canadian transportation deregulation.



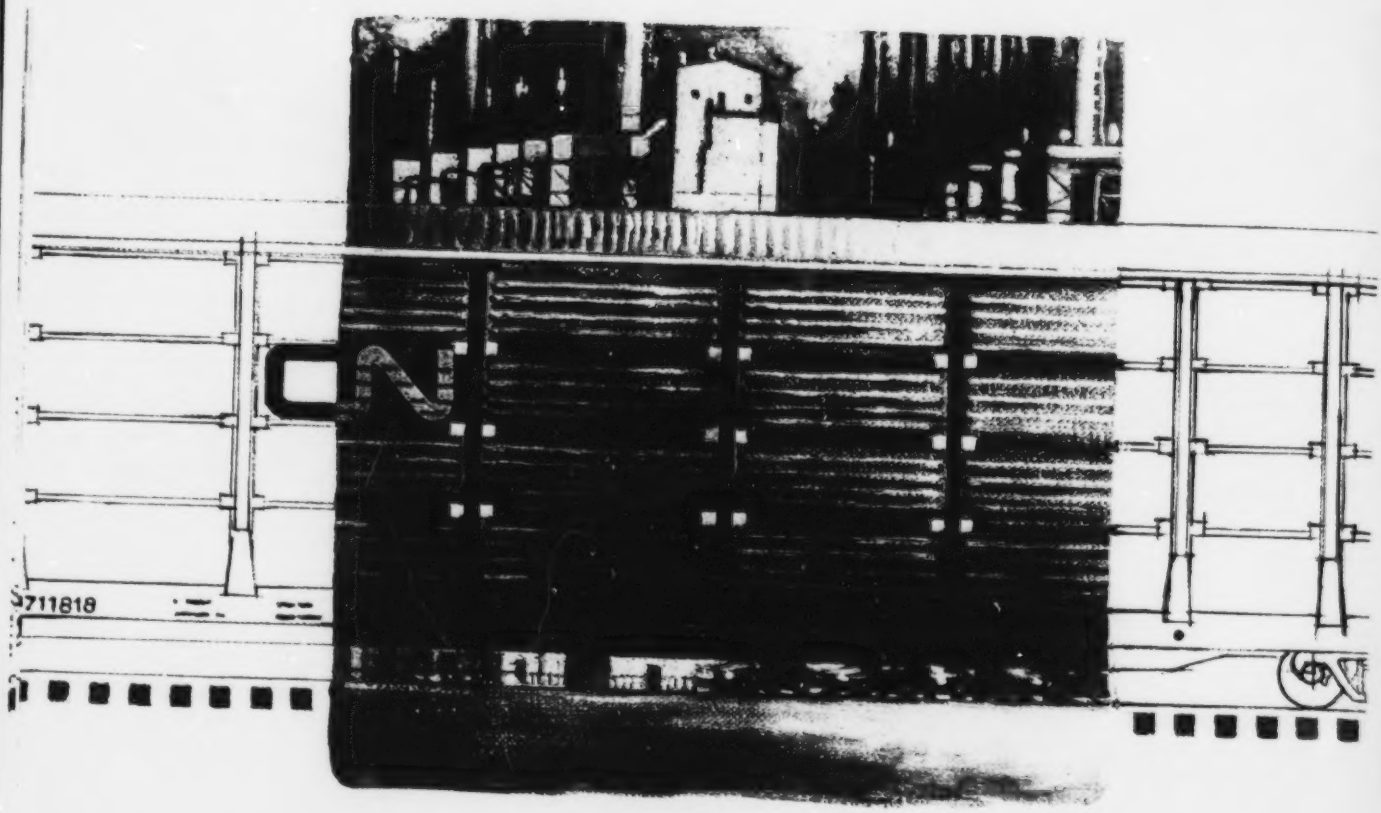
The petroleum and chemical products commodity group is responsible for ensuring customer satisfaction in this sector. The tank cars shown at an oil refinery in Ontario were leased by a customer from a freight car leasing company, the normal practice in transporting petroleum products.

The painting at left shows a CN covered hopper car used in transporting flowable bulk commodities, in this case, plastic pellets. CargoFlo service allows customers to perform break-bulk distribution to final destinations. On this page, a CN sales officer and a representative of a chemical company discuss CN's Customer Information Services for data interchange by computer.

These moves include:

- Revamped and modernized intermodal terminals at Moncton and Montreal.
- Chicago/Moncton Laser train service for container and trailer traffic.
- New steel and chemical distribution centres.
- A joint Grand Trunk Western/Burlington Northern intermodal train service (Expediter) which extends the CNGT network into additional major U.S. markets.
- New train service arrangements to speed the shipment of B.C. lumber to midwest and eastern points in the United States.

Provisions of the new National Transportation Act, 1987, permitting confidential freight contracts should accelerate the development of service packages and patterns. In short, CN looks forward to being a leader in Canada's new transportation era.

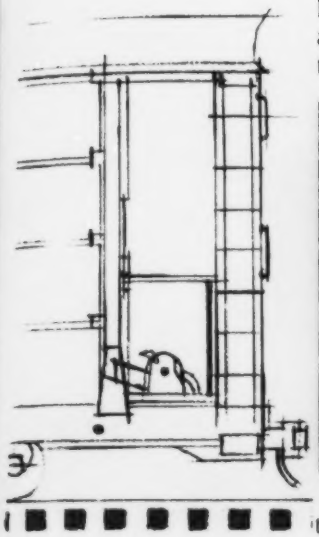


LOOKING AT

FREER TRADE

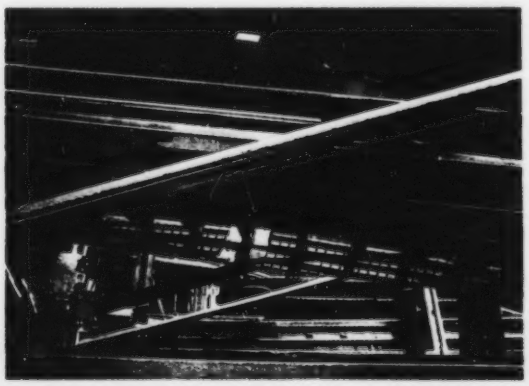
The prospect of freer trade with the United States is an important development for Canada and for Canadian National.

Canada is a major trading nation, with close to 30 per cent of its gross national product accounted for by exports, and CN is a company which moves these products to markets.



The initiative comes at a time when protectionism is once again on the rise throughout the world. The growing use of quotas and voluntary export restriction agreements, together with the growth in trade in services, is threatening the principle of freer trade among nations.

For Canada, and for CN, this threat is distressing. But with respect to the United States, strong continental ties already exist. More than 25 per cent of Canada's railway traffic flows across the U.S. border.



Freer trade, then, should bring a number of benefits to Canada and to Canadian National:

- The close relationship between Canadian industry and the nation's transportation infrastructure will inevitably be strengthened.
- Access to U.S. markets should improve Canada's ability to compete and accelerate its economic adjustment, making it a stronger competitor around the world.
- Freer trade will strengthen the Canadian manufacturing sector by encouraging foreign and domestic investment in locations which enjoy advantages in terms of labor productivity, raw material availability and transportation services.
- The existing economic patterns upon which freer trade is largely based will serve as a model for future multilateral agreements and thus counter the growing international movement towards protectionism.

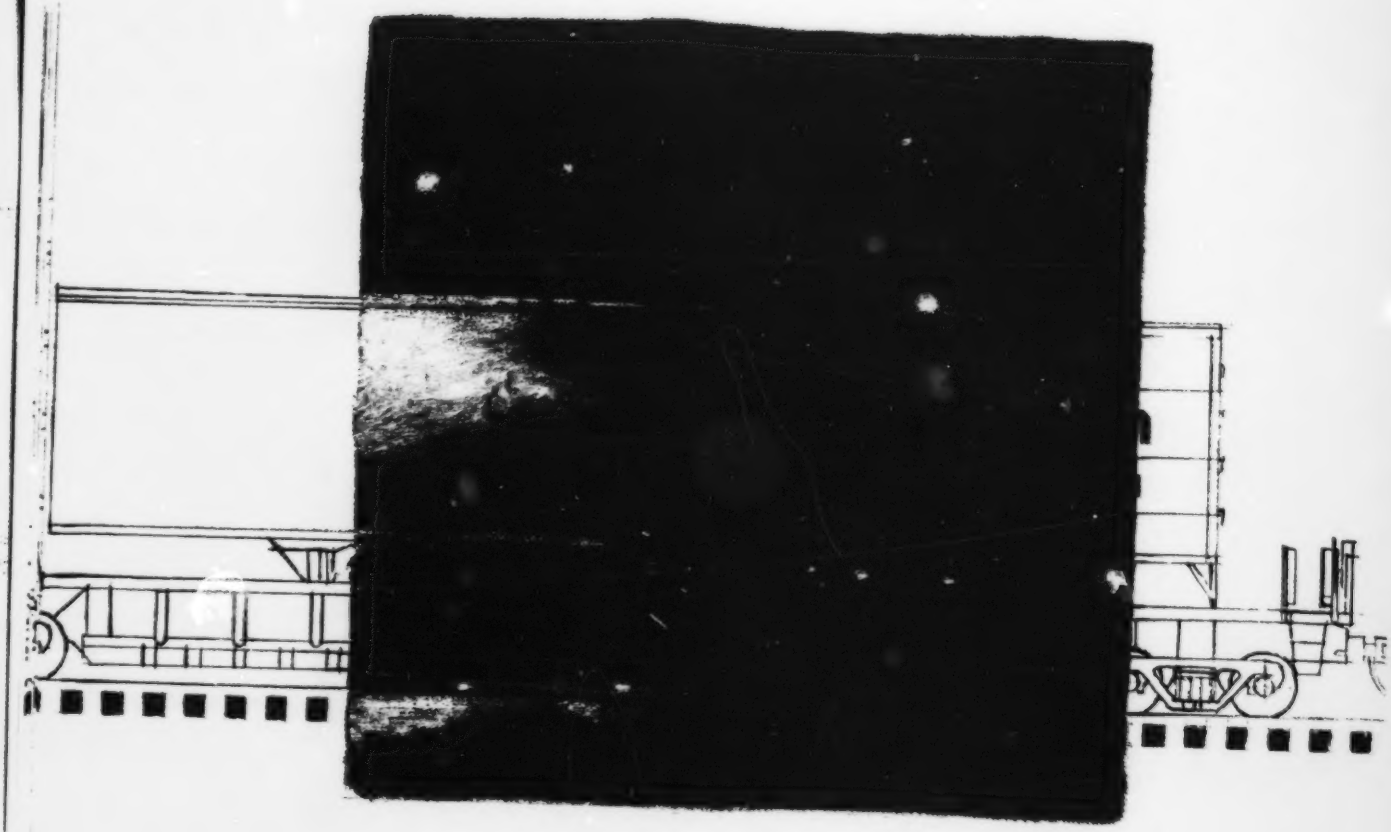
For the automotive industry CN supplies specialized multi-level freight cars, depicted in the painting at left. Photos above show an adjustable ramp to facilitate unloading, and the interior of a loaded tri-level car.

Successful sectoral trade agreements involving Canada and the United States have been in place for some time. The free movement of automobiles and auto parts across the border accounted for almost $12 billion in Ontario export revenue in 1986 and is the bedrock of that province's economy. Canadian National has been intimately involved in transporting these products and the company is proud of some of the innovative transportation services it has designed in doing so.

But the company recognizes that if increased north/south movement of goods is accompanied by a reduction in traditional east/west traffic patterns within Canada, significant adjustment would be required to the infrastructure and facilities in which the company has invested over the years primarily to accommodate interprovincial freight transportation requirements. Freer trade with the United States also opens the door to greater competition from American railways and trucking firms.

CN's U.S. subsidiary railroads, under the Grand Trunk Corporation, figure prominently in international auto transportation. Photo shows locomotives sorting loaded automobile cars at a major auto plant in Michigan.

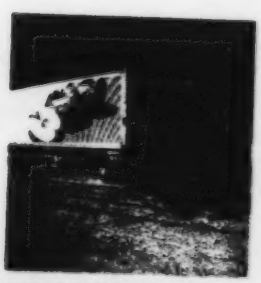
Nonetheless, as the provider of a key service to the Canadian economy, CN welcomes the challenge that comes from freer trade. Under liberalized trade conditions, Canadian industries will realize economies of scale and create increased demand for transportation services. Canadian National is prepared to seize the opportunity and provide the services and facilities required.



THE NATIONAL TRANSPORTATION ACT

OF 1987, AND BEYOND

The National Transportation Act, 1987, gave the Canadian rail industry the right to negotiate confidential contracts with its customers. This will help the railways cement existing business partnerships and develop new ones in today's highly competitive global economy.



Although the new legislation does not go far enough in allowing Canadian railways to control costs, and introduces provisions allowing U.S. railways extended access to Canadian traffic, it does provide important freedoms at a time when new responses to a new market environment are imperative.

Today, many shippers are looking for much more than the ability to carry goods from one point to another at the lowest possible rate. They want their carrier of choice to assume responsibility for the entire chain of movement and are demanding comprehensive transportation service/price packages.

Over the past several years, CN has focused a growing share of its resources on meeting this new demand by developing intermodal and multimodal services which transcend traditional rail carrier activities. The key concept of a high-traffic core railway serving a network of transfer and distribution centres has been used successfully for many product groups, including newsprint, lumber, steel, automobiles, and plastic pellets.

The overall environment in which the railways are working will foster the development of more innovative and imaginative solutions to distribution problems.

The legislation has other positive features:

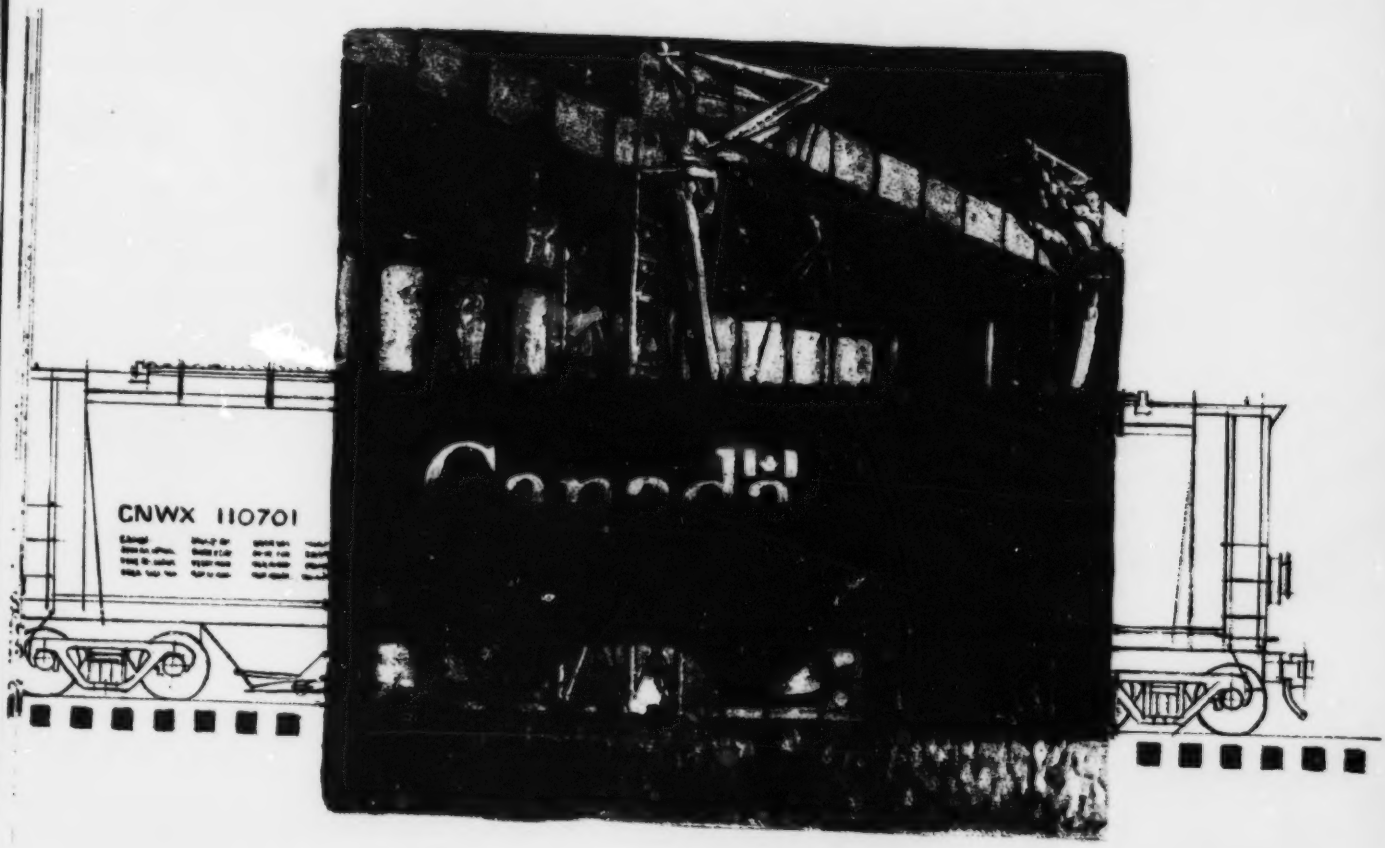
- It changes the terms under which railways may abandon unprofitable rail lines. The provisions will help CN reduce high maintenance and capital costs for unproductive track, since one third of the company's track mileage accounts for only one per cent of total freight traffic. The possibility of transferring ownership of portions of the network to short-line or regional railway operators also promises to help reduce operating costs while preserving economically feasible railway traffic patterns.
- A limit has been placed on the time the National Transportation Agency may take to process an abandonment application.

Intermodal is CN's fastest growing line of business. It includes trailers on rail cars, as illustrated in the painting at top left, and international containers, as shown in the port scene above. Manufacturers are increasingly using CN Intermodal services to gain the efficiency and reliability of rail along with the flexibility of road for local distribution.

Featured in CN's marketing communications advertising, this photo shows an intermodal trailer being loaded at a cookie factory. CN developed the specialized damage prevention equipment for this most fragile commodity.

- The National Transportation Agency has been mandated to reduce bureaucratic rigidity. It is expected to monitor the fulfillment of overall transportation objectives, rather than becoming caught up in detailed rail regulations.

From CN's perspective, the NTA, 1987 is clearly an attempt to bring the regulatory environment surrounding railway operations into better alignment with economic realities. The company recognizes that more intense competition will mean some revenue loss, which will intensify pressure to control the cost side of the equation. However, CN understands the important goals set by the legislation, and welcomes the prospect of being able to compete in the marketplace.



TECHNOLOGY AS A KEY TO MARKET SUCCESS

Safety. Efficiency. Cost control. Reliability. The right mix of tailored services. New railway and information systems technology is essential to achieving each of these objectives. Over the past year, CN has continued to implement new methods and processes which work towards enhancing its competitive position, its cost-effectiveness, and its safety record.

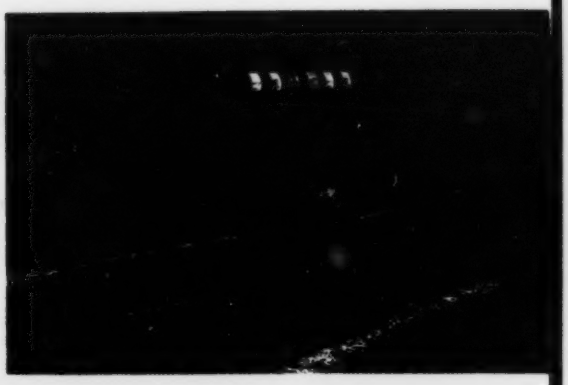
CN's safety record has ranked among the best of all North American railways over the past decade. Nonetheless, the company continues to make efforts to improve that record, by instituting new technological and management systems allowing the company to approach fail-safe operations.

Following release in January 1987 of the Foisy Commission report on the CN/VIA collision at Hinton, Alberta, a year earlier, CN committed itself to accelerating the search for and implementation of new safety-related methods, procedures and technologies. Initiatives included:

- Installation of reset safety control devices in all main-line locomotives. This mechanism applies the brakes automatically should members of the train crew be unable to do so.
- Acceleration of a program to install hot box and dragging equipment detectors, trackside devices capable of communicating with the crews of passing trains.
- Inspection of 40,000 miles of trackage by two CN-designed track geometry cars (TEST cars) to identify any developing defects which might adversely affect safe train operation.
- Installation of an Overloaded Car Detector at Jasper to monitor the loads of unit trains carrying grain and other bulk commodities.

To enhance railway efficiency and service to customers, CN continued to develop and implement advanced computer and communications systems, including:

- Customer Information Services (CIS), a simple and flexible approach to electronic data interchange with customers.
- Completion of a three-year, $33-million project undertaken jointly with CNCP Telecommunications to install fibre optic cable along the Vancouver/Edmonton main line, enhancing the speed, quality and reliability of railway communications.
- Continued participation in the Advanced Train Control Systems project (ATCS), a co-operative venture by Canadian and U.S. railways to apply sophisticated computer technology to the operation of trains.



This grain train in Alberta is powered by the latest model diesel locomotive, made in Canada, and incorporating many high-technology features to improve efficiency and productivity.

In the area of cost reduction, CN and CP Rail obtained the approval of the Railway Transport Committee of the Canadian Transport Commission for limited operation of cabooseless trains. Following the negotiation of appropriate collective agreement provisions, and implementation of appropriate technology, cabooseless operations should save the company more than $30 million annually.

CN also worked towards achieving cost savings by consolidating work performed in its main shops. Operations at the Moncton shops were gradually wound down during the year, with complete closure planned for the end of September 1988.

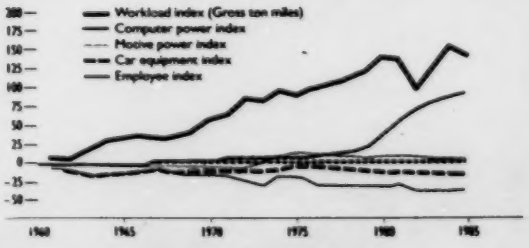
To cope with surplus capacity at its Pointe St. Charles shops, CN took steps to transform that facility into a contract enterprise.

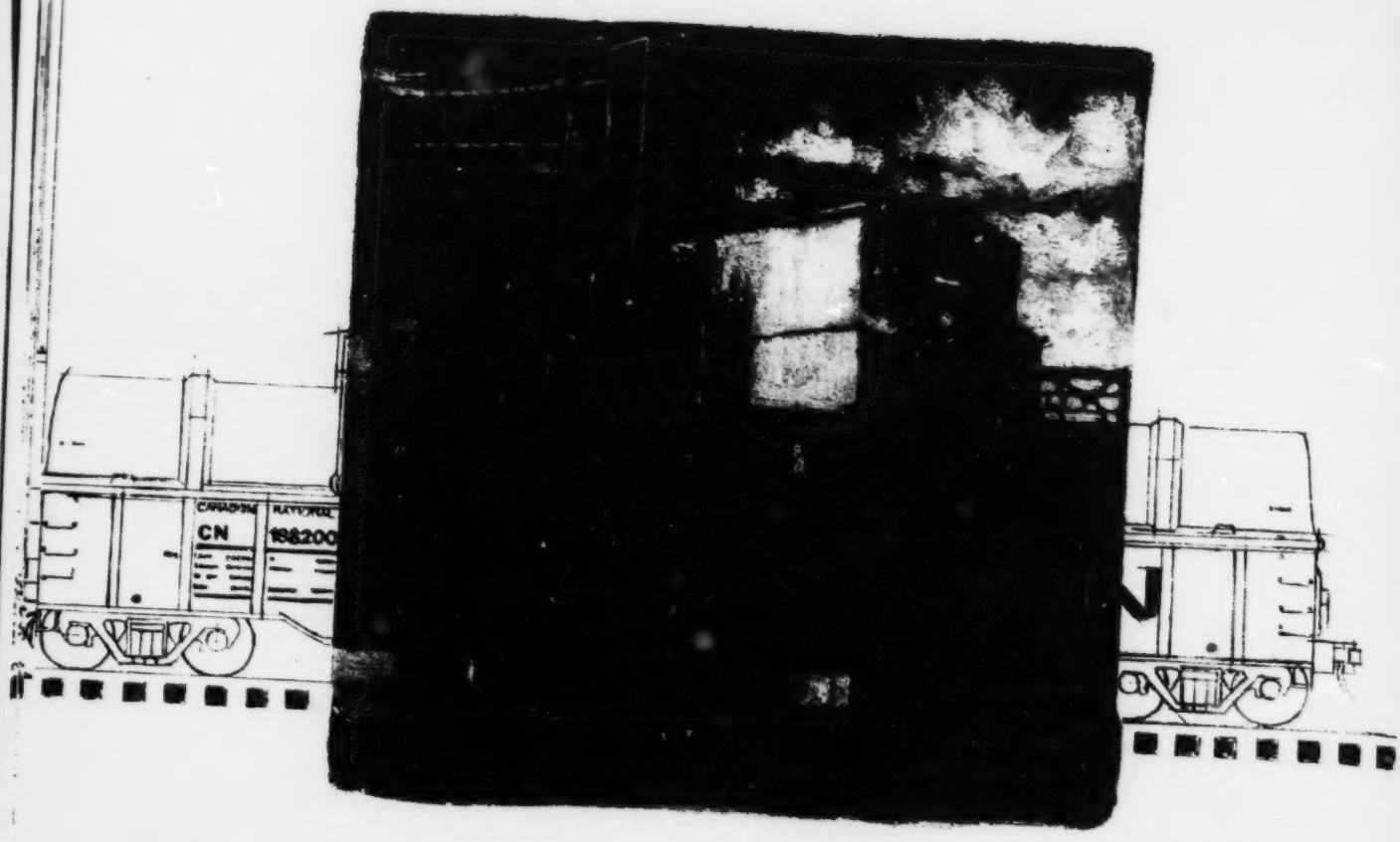
Technological leadership over the years has established CN firmly as an exporter of transportation and telecommunications expertise and technology through its subsidiary Canac International. During 1987, Canac extended the scope of its commercial activities to a total of 26 countries on all six continents.

Canada ships grain worldwide, and CN carries it from prairie elevator to ocean and lake ports. The painting, top left, shows a government-owned grain hopper car against a backdrop of terminal elevators at Thunder Bay. The photo above shows grain being loaded into one of these cars in Manitoba.

PRODUCTIVITY IMPROVEMENT AS REFLECTED IN CHANGING PROPORTIONS AMONG RESOURCES EMPLOYED BY CN TO PERFORM AN INCREASING WORKLOAD

1960 – 1985





PEOPLE:

THE RENEWABLE

RESOURCE

Like other companies compelled by competitive pressure to cut costs and upgrade productivity, CN faces a dilemma in attempting to reconcile seemingly conflicting responsibilities with regard to its work force.

The company has always recognized people as its most valuable asset, a resource upon which it depends for ideas, innovation, and productive achievement. People, in fact, constitute a renewable resource, one which does not depreciate over time but is capable of growth through learning and experience.

But at a time when the competitive environment demands significant cost reduction, the company must seriously address the cost of labor, which currently represents almost 60 per cent of its operating expenditure.

The problem is how to retain and develop a strongly committed and motivated group of employees, while dealing compassionately with those members of the work force who, through no fault of their own, are no longer in a position to contribute towards corporate goals. Contract negotiations, which led to a five-day strike in August, reflected, in a sense, the challenge of resolving the dilemma.

To achieve the objectives, CN is committed both to creating incentives for personal growth, and to minimizing individual hardships flowing from downsizing action through a combination of enlightened separation and assistance programs.

As a responsible employer and in recognition of society's larger goals, CN has also implemented human resource policies which are attuned to today's needs while, at the same time, enhance the quality of its work force and services. Initiatives include:

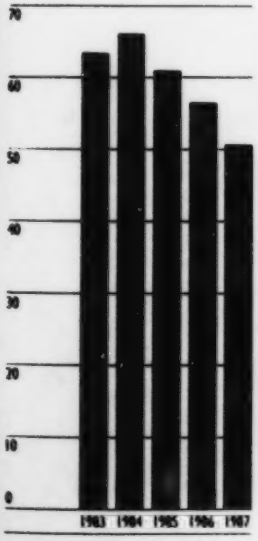
- Compensation, job evaluation, performance assessment, and training programs designed to create incentives and foster skill development.
- A customer awareness campaign to promote customer-oriented behavior throughout the work force.
- Expansion of employment equity programs to increase opportunities for and representation of women, native peoples, members of visible minorities, and the disabled.
- Extension of the company's chemical dependency assistance program to alleviate personal difficulty and enhance safety and productivity.

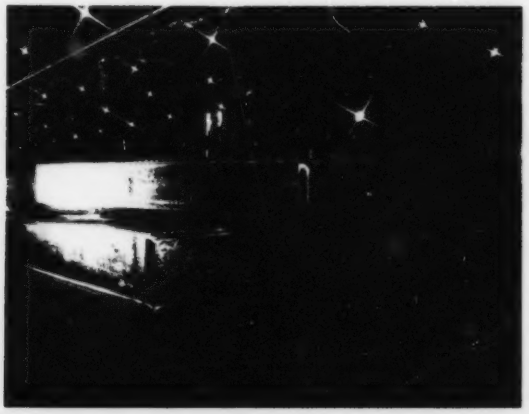
CN also maintained its commitment to improve pension benefits in order to help retired employees or their survivors cope with the rising cost of living. In 1987, $160 million was allocated to increases in benefits over a four-year period and the proportion of recipients eligible for increased payments was expanded from 50 to 70 per cent.

As in the past, every effort is being made to reduce staff numbers through attrition. Where this is not possible, CN offers a variety of programs to help individuals bridge the transition. These programs include early retirement packages, generous separation payments, opportunities for retraining, assistance in finding other employment, and, for unionized employees, the employment security provisions of their collective agreements. CN is and will remain committed to finding reasonable and compassionate solutions.

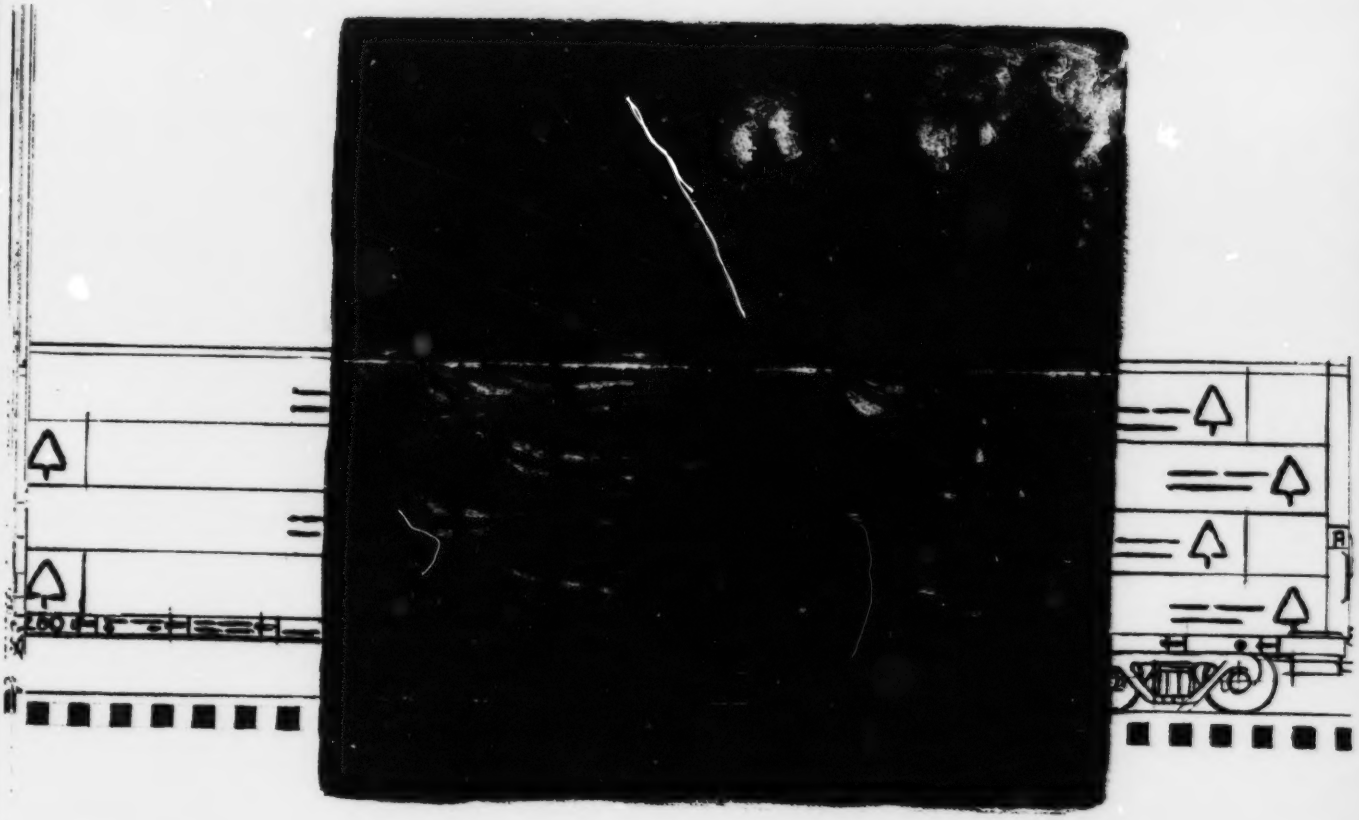
AVERAGE NUMBER OF CN EMPLOYEES

in thousands





CN people are becoming increasingly responsive to customers' more complex distribution needs, and shippers of ores, minerals and metals are among those reaping the benefits. The car in the painting, left, carries steel or aluminum coils. Photos show: left, a coil being loaded; above, aluminum ingots on a bulkhead flatcar, and a CN sales officer with a customer.



AN EVOLVING CORPORATION

While CN posted a profit in 1987, earning net income of $120.6 million, system indebtedness, now at $3.0 billion, remains unacceptably high. Management is aware that the company urgently needs strong action to secure its viability in a future expected to be marked by increasing competition, scarce capital, and uncertain revenue growth.

With no access to equity either from the shareholder or through public equity offerings, management's top priority has been to pursue measures which will facilitate debt reduction by means of internally generated funds.

Since recapitalization of the company in 1978, CN has been responsible for sustaining its own financial self-sufficiency. Its capital needs have been met solely through commercial borrowings, earnings, and sale of surplus assets.

However, capital needs during the period following recapitalization were unusually high, mainly because of heavy expenditure required to expand railway capacity in Western Canada and performance of a number of imposed public duties for which the company received no compensation from the Government of Canada.

As a result, CN was compelled to borrow heavily at a time when interest rates were at their peak. Interest charges amount to approximately one million dollars a day, or $372 million in 1987. Debt ratio rose from 40 per cent in early 1978, to 52.8 per cent in 1986.

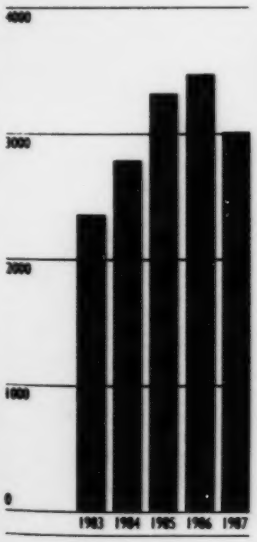
Some progress was achieved in 1987. Internally generated funds were sufficient to allow the retiring of certain bond issues that had come due, without new borrowings. The result was a reduction of more than $300 million in long-term debt, and a 1987 debt ratio of 48.6 per cent.

Strategy for further debt reduction includes:

- Improving CN's market position by restructuring, refocusing and streamlining its organization.
- Reducing costs by consolidating or eliminating redundant staff and facilities.
- Seeking appropriate compensation for imposed public duties.
- Exploring the possibility of further divestiture.

CN INDEBTEDNESS

In millions of dollars



At the beginning of 1988, CN announced the formation of a separate commodity group for lumber and wood products. Much of the lumber leaving mills in Eastern and far Western Canada is carried on high capacity flat cars as illustrated in the painting, top left. The photo above shows customer representatives at the Niagara Falls lumber transfer yard.

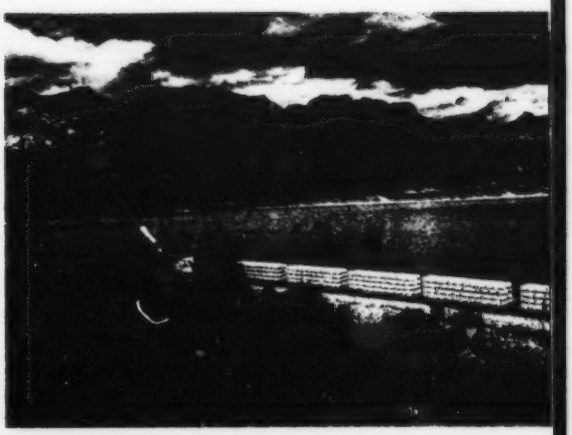


Photo above shows cars loaded with packaged lumber for U.S. markets in the East. Lumber transfer yards have been developed to permit customers to break carload lots into smaller shipments for local delivery by truck.

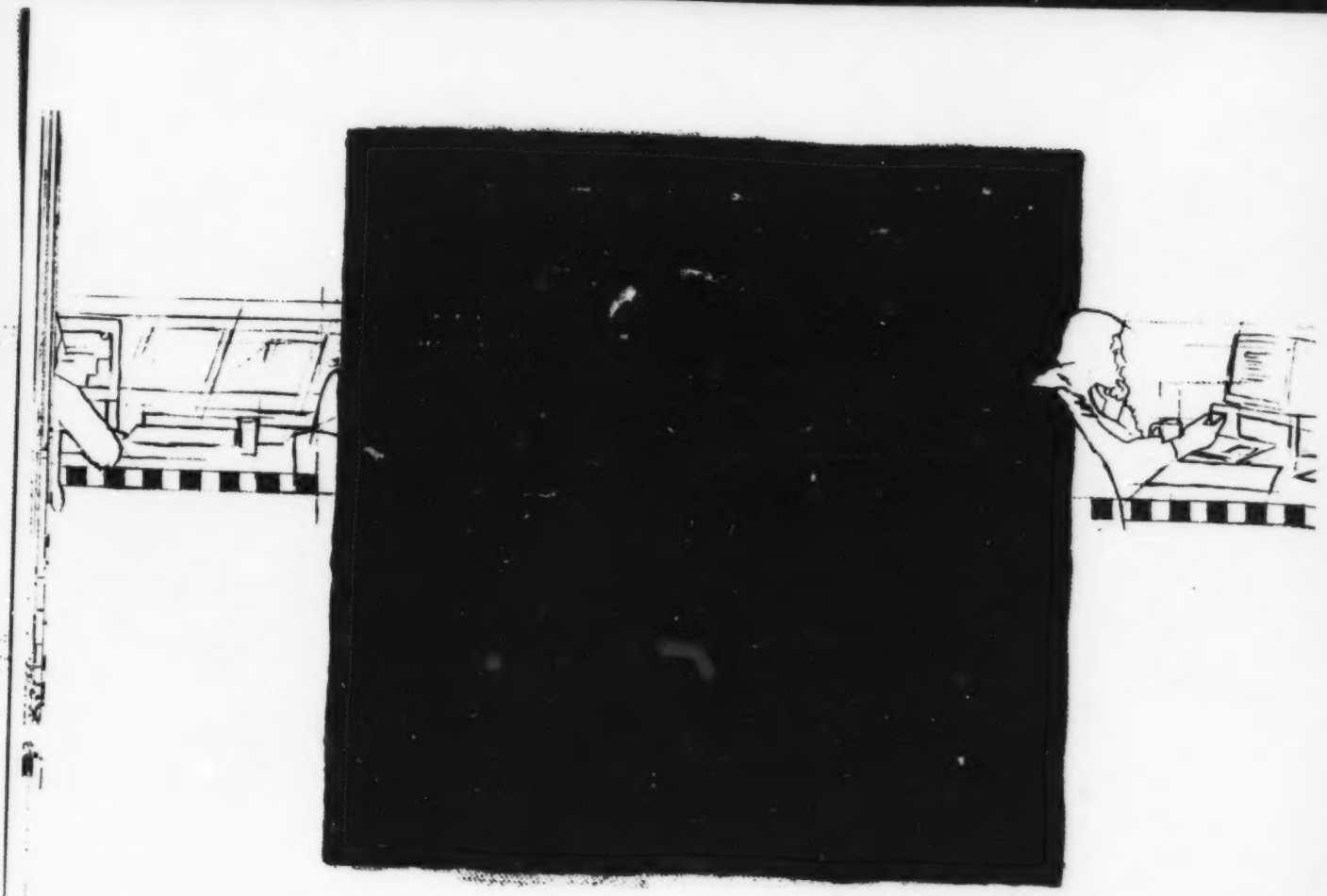
The guiding principle for divestiture is to ensure that the price obtained from sale will exceed the value of the properties were they to remain in CN hands.

During 1987, CN began a systematic process leading in January 1988 to an agreement to sell its nine-property hotel chain for $265 million, including working capital. The agreement contains guarantees by the purchaser to honor existing labor contracts and salaries, to maintain pension benefits, and to continue operation of the properties as first-class establishments.

The management consulting firm Booz.Allen & Hamilton Inc. carried out extensive studies during 1987 into CN's structure and preparedness to meet competitive challenges. The result is adjustments aimed at enhancing its market position.

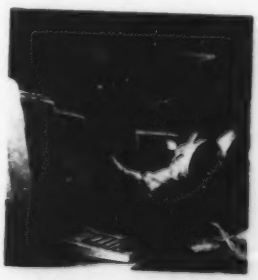
These adjustments include: reorganizing the Marketing function to take better advantage of commercial opportunities; streamlining the Operations function through decentralization of decision-making and better co-ordination among its three components; and a sharpened focus on planning at the executive level to ensure integration and co-ordination of strategic, business, and financial plans.

CN management is involved in continual discussion with its shareholder, the Government of Canada, regarding adequate compensation for remaining imposed public duties. At this time, the outlook for resolution of these issues is promising.



ADDING IT ALL UP

It has been said that the temper of the times forces differing accommodations. To some generations much is given. From others much is expected. Canadian National, whose markets were secure only a few short years ago and which now faces unparalleled competition, clearly belongs to a generation to which much was given and from which much is also expected.



For the past several years, the company's annual reports have detailed the many changes underway within CN in response to its rapidly changing environment. They described Canadian National as a company in transition, preparing itself for fundamental reorientation. Today, the transition period is drawing to a close; the groundwork has been laid, the direction made clear, and the company is now on the move. Its financial performance in 1987 indicates as much.

Canadian National has successfully adapted and adjusted its corporate goals and resources to the fact of change, to the realities of a global marketplace, and to the challenges of increased competition. The company's views on freer trade and its response to the National Transportation Act, 1987, exemplify the positive and constructive stance being taken in recognition of the different role railways must now play.

The implementation of an aggressive new marketing strategy is another example of a major step forward. The strategy is built around customer-driven services and on an understanding that the company must continue to find favorable market niches and to create appropriate products

and services to fill them. But a new marketing strategy, no matter how well conceived, must be managed and supported properly.

Many of the changes needed to improve productivity are being accomplished with minimal disruption and were concentrated in four areas: network and terminal rationalization; the application of better and more innovative technology; the paring down of under-utilized maintenance shops; and improved administrative efficiency.

CN people are intensively occupied in planning the company's response to a vastly changed marketplace. The painting opposite groups a variety of planning aids including task forces, studies, computer simulation, network models. Lower photo shows employees working at Customer Information Services computers.

Key to CN's future is the productivity and commitment of its people. Training programs, as portrayed in the top photo, enhance quality of effort, while the yardperson, below, exemplifies the intent of employment equity initiatives to ensure fair representation in the work force.

The task is not easy nor without disruption to employees. But, as in the past when such action was inevitable, the company is doing its best to accommodate people affected by organizational and technological change by carefully planning its implementation and offering a variety of assistance programs.

Adding it all up, then, the message of this year's annual report can be summarized simply: Canadian National is a company positioned and anxious to fulfill its changed role within national policy and the competitive environment. The company has a sound marketing plan, a dedicated management team, and a skilled and supportive staff. It can also count on its record of developing and using state-of-the-art technology, and its history of conspicuous and significant achievement when facing challenges and opportunities.

DIRECTORS

As at December 31, 1987

B. O'N. Gallery
Acting Chairman
Westmount, Quebec
(2) (3)
Appointed Acting Chairman
effective January 1, 1987

A.J. Bentley
Saskatoon, Saskatchewan
(1) (5)

J. Brouwer
West Vancouver,
British Columbia
(2)

E. Demkiw
Vegreville, Alberta
(2) (3)

J. Johnson
Winnipeg, Manitoba
(2) (3)

R.E. Lawless
President and
Chief Executive Officer
Beaconsfield, Quebec
(2) (3)
Appointed President and
Chief Executive Officer
effective January 1, 1987

M. Marchand
North Bay, Ontario
(4) (5)

E.A. Mascoll
Toronto, Ontario
(2) (4) (5)

C.J. Stagg
Stephenville, Newfoundland
(1) (4)

G.T. Urquhart
Moncton, New Brunswick
(1) (5)

J.S. Hinds, Q.C.
end of term December 31, 1986

(1) Member of the Audit Committee

(2) Member of the Compensation Committee

(3) Member of the Investment Committee

(4) Member of the Social Responsibility Committee

(5) Member of the Real Estate Committee

OFFICERS

as at December 31, 1987

B. O'N. Gallery
Acting Chairman

R.E. Lawless
President and Chief Executive Officer

M.A. Blackwell
Vice-President
Atlantic Region

R. Boudreau, Q.C.
Vice-President – Law

D.C. Campbell
President
CN Communications

F.D. Campbell
Vice-President
Prairie Region

T. Cedraschi
President and Chief Executive Officer
CN Investment Division

G.C. Church
Treasurer

P.A. Clarke
Senior Vice-President
Marketing

A.E. Deegan
Vice-President
Great Lakes Region

M.L. De Pellegrin
President
Canac International Inc.

B.E. Ducey
Vice-President
Public Affairs & Advertising

J.H. Easton
President and General Manager
TerraTransport

D.L. Fletcher
Senior Vice-President
Operations

P.J. Foliot
Vice-President
Purchases and Materials

J. Horrocks
Vice-President
Finance and Planning

C.J. Hudson
President
CNM Inc.

J.R. Lagacé
Vice-President
St. Lawrence Region

G.W. Lange
Vice-President
Corporate Strategy

J.P. Laroche
Vice-President
Employee Relations

G.L. Maas
President
Grand Trunk Corporation

G. Maroulis
Vice-President
Internal Audit

Y.H. Masse
Senior Vice-President & Chief Financial Officer

R.G. Messenger
Vice-President – Corporate

W.H. Morin
Group Vice-President

A.R. Pozniak
Vice-President
Information Systems

H.J.G. Pye, Q.C.
Vice-President and Secretary

C.J. Sauvé
President
CN Hotels Inc.

J.H.D. Sturgess
Senior Vice-President & Chief Operating Officer

S.D.H. Thomas
Corporate Comptroller

H.D. Tipple
President
CN Real Estate

D.E. Todd
Vice-President
Government Affairs

W.H. Waddell
President
CN Exploration Inc.

R.A. Walker
Senior Vice-President
Western Canada

COMPANIES

Companies included in the Consolidated Financial Statements of the Canadian National Railway System as at December 31, 1987

Consolidated Companies

Autoport Limited

Canac International Inc.

Canadian National Express Company

Canadian National Railway Company

Canadian National Steamship Company, Limited

Canadian National Telegraph Company

Canadian National Transfer Company Limited

Canadian National Transportation, Limited

Canat Limited

Canaven Limited

Central Vermont Railway, Inc.

Chapman Transport Limited

CN Exploration Inc.

C.N. (France) S.A.

CNM Inc.

CN Tower Limited

CN Transactions Inc.

Domestic Four Leasing Corporation

Domestic Three Leasing Corporation

Duluth, Winnipeg and Pacific Railway Company

E I D Electronic Identification Systems Ltd.

Empire Freightways Limited

Grand Trunk Corporation

Grand Trunk Land Development Corporation

Grand Trunk Radio Communications, Inc.

Grand Trunk Western Railroad Company

Mount Royal Tunnel and Terminal Company, Limited

Northwestel Inc.

Royal Transportation Limited

Terra Nova Telecommunications Inc.

The Canada and Gulf Terminal Railway Company

The Canadian National Railways Securities Trust

The Canadian Northern Quebec Railway Company

The Great North Western Telegraph Company of Canada

The Minnesota and Manitoba Railroad Company

The Minnesota and Ontario Bridge Company

The Northern Consolidated Holding Company Limited

The Quebec and Lake St. John Railway Company

Jointly-Operated and other Companies in which the System has Investments

Canadian National Hotels (Moncton) Ltd.

Canaprev Inc.

Chicago and Western Indiana Railroad Company

CN Hotels Inc.

Compagnie de gestion de Matane Inc.

Computer Sciences Canada, Ltd.

Detroit River Tunnel Company

Dome Consortium Investments Inc.

Domestic Two Leasing Corporation

East Yard Development Ltd.

Eurocanadian Shipholdings Limited

Fort Point Holdings Ltd.

Halifax Industries (Holdings) Limited

Halterm Limited

Lakespan Marine Inc.

Railroad Association Insurance, Ltd.

Seabase Limited

Shawinigan Terminal Railway Company

Société du port ferroviaire de Baie Comeau-Hauterive

Telesat Canada

The Belt Railway Company of Chicago

The Canada Southern Railway Company

The Public Markets, Limited

The Toronto Terminals Railway Company

Trailer Train Company

In addition, the property of the Canadian Government Railways is entrusted to the Canadian National Railway Company as part of the System.

FINANCIAL REVIEW

RESULTS OF OPERATIONS

System net income for 1987 was $120.6 million compared with a net loss of $86.3 million in 1986 and net income of $117.6 million in 1985. The largest portion of the 1987 improvement was generated by CN Rail which experienced higher traffic volumes, led by record export grain movements, and expense reductions. Results also improved in Grand Trunk Corporation, CN Real Estate, CN Exploration, Other Enterprises and TerraTransport. Results for CN Communications and CN Hotels fell below the 1986 level. Included in the 1987 improvement was $86.7 million attributable to the disposal of CN Route and the Dockyard, both of which incurred losses in 1986. However, in 1987 the Company made a $43.1 million provision for the impairment of TerraTransport assets which was accounted for as an extraordinary item (see Note 3 of Notes to Consolidated Financial Statements).

Significant factors in the 1986 loss were non-recurring items including the shut-down costs and loss on disposal of CN Route, an adjustment to the VIA Rail Canada Inc. (VIA) contract, the write-down of an investment by Grand Trunk Corporation, a provision for loss on disposal of Dockyard operations in Newfoundland, and increases in casualty loss provisions on the Grand Trunk. In aggregate these items approximated the amount of the net loss for 1986. The income decline was general, with all divisions' results being below the 1985 level except CN Hotels, CN Real Estate and Other Enterprises.

The results for each division, which are discussed below, include the assignment of interest expense. This expense aggregated $371.9 million for the System in 1987, $382.3 million in 1986 and $336.2 million in 1985. The 1987 decrease is due mainly to reduced debt and the strengthening of the Canadian dollar against the U.S. dollar. The increase in 1986 was attributable to an increase in effective interest costs and a higher debt level. See Note 11 of Notes to Consolidated Financial Statements.

CN RAIL

CN Rail's income amounted to $111.4 million in 1987 compared with a loss of $11.2 million in 1986 and income of $105.5 million in 1985. Increased freight revenues and lower operating costs were the main factors in the 1987 improvement. Decreased income from VIA, along with increases in non-operating expenses including a special charge relating to work force reductions, accounted for nearly all of the 1986 decline.

Railway operating revenues totalled $3,716.4 million in 1987, up $63.7 million from 1986, but $36.8 million below 1985. Freight revenues were $130.7 million higher than in 1986, mainly because of increased traffic volumes, particularly in the grain, forest products and intermodal groups. Partially offsetting this improvement were declines in revenues from coal, sulphur, potash and automotive, and the revenue reduction occasioned by the volume-related limitation on amounts collectible under the Western Grain Transportation Act for the crop year ended July 31, 1987. Lower receipts from VIA due to the transfer of responsibility for certain activities to VIA and lower workloads were also a moderating factor in the 1987 revenue level. Revenues were also reduced by hedging currency exchange losses on U.S. long-term debt repayments with currency exchange gains realized on interline freight revenues.

The most significant factor in the 1986 revenue reduction was lower revenue from VIA due to the transfer of various activities to VIA and a $52.6 million reduction in the reimbursement level for VIA costs. Freight services revenues rose by $20.9 million mainly from higher rates and traffic volume increases in the grain and intermodal segments. These were sufficient to offset traffic reductions in forest products because of industry strikes and U.S. countervailing duties, in automotive because of reduced production and in potash, sulphur and coal due to lower demand.

Expenses in 1987 were $3,605.0 million, down $58.8 million from 1986 and $42.6 million from 1985. The principal factors in the 1987 reduction were lower operations costs which were achieved despite higher traffic volumes and workloads. Most of the improvement was due to lower equipment and roadway maintenance expenses, lower fuel costs, reduced workloads under the VIA contract, productivity and other miscellaneous savings resulting from staff reductions. Non-operating expenses were higher than in 1986, mainly because of fringe benefit, insurance, bad debt, tax and interest costs. The 1986 operating expenses were below the 1985 level mainly because of reduced workloads under the VIA contract, productivity improvements and the drop in fuel prices. However, this reduction in operating expenses was more than offset by increases in non-operating expenses including pension, interest, tax, depreciation, fringe benefit and separation costs.

GRAND TRUNK CORPORATION

Grand Trunk Corporation had income of $21.8 million in 1987 compared with a loss of $14.2 million in 1986 and income of $13.6 million in 1985. Included in the results for both 1987 and 1986 was significant non-recurring other income. In 1987 such non-recurring income accounted for most of the net income and included the sale of two branch lines, certain tax shelters and other assets. The 1986 non-recurring other income, mainly the settlement of a court case and income from fibre optic contracts, was only slightly less than that for 1987. Lower 1987 employment levels and several major non-recurring expense items in 1986 were the main factors in the 1987 improvement. These 1986 expense items, along with lower traffic volumes and average unit revenues were the main contributors to the 1986 decline.

Revenues amounted to $486.0 million in 1987, $531.4 million in 1986 and $551.8 million in 1985. Traffic volume fell in 1987, with automotive, forest products, potash and hazardous materials showing the largest declines. In addition, unit revenues were down, average hauls decreased, and there were unfavourable changes in the commodity mix. Volume declines, increases in contract allowances and rate discounts depressed the 1986 revenue level.

Expenses totalled $464.2 million in 1987, $545.6 million in 1986 and $538.2 million in 1985. The main factors accounting for the 1987 improvement in expenses were reductions in employment levels, divisional consolidations, yard closings, lower traffic volumes, productivity gains and 1986 non-recurring expense items. The main reasons for the 1986 rise in expenses were a number of non-recurring adjustments including an increase in casualty loss accruals, provision for separation payments to train crew employees, the write-off of a receivable from a major customer in financial difficulties and a write-down in the value of an investment. Offsetting factors were the non-recurring other income items and productivity gains.

ENTERPRISES GROUP

CN Communications

CN Communications' income in 1987 was $21.4 million, compared with $36.2 million in 1986 and $43.0 million in 1985. The $14.8 million reduction in 1987 was mainly due to the writedown in the value of certain assets of CNCP Telecommunications and Telecommunications Terminal Systems. In addition, revenues fell because of the steadily increasing competition from alternatives to telex services. The $6.8 million decrease in 1986 was mainly due to the reduced income from telex services, the transfer of pole line operations to CN Rail, an increase in pension costs and inflationary cost increases.

CN Exploration

CN Exploration earned income of $10.6 million in 1987, $4.5 million in 1986 and $39.5 million in 1985. Increased crude oil prices as well as decreased operating and interest expenses contributed to the 1987 increase. In 1986, the severe decline in oil prices caused the fall in income despite a 12.1% increase in production.

CN Real Estate

Income from CN Real Estate amounted to $37.8 million in 1987, up $19.0 million from 1986 and $23.1 million from 1985. In 1987 the increase was due mainly to higher property disposal income. In 1986, increased income from property operations and higher interest income more than offset reduced profits from land sales.

Other

Other Enterprises had income of $7.5 million in 1987, $7.5 million in 1986 and $4.2 million in 1985. In 1987, increased income from CN Tower and C.N. (France) S.A. offset the declines in Canac International Inc. and CNM Inc. A marked improvement in the results of Canac International Inc. coupled with higher income from CN Tower accounted for the 1986 betterment.

TERRATRANSPORT

The loss incurred by TerraTransport in 1987 was $39.0 million compared with losses of $41.3 million in 1986 and $39.9 million in 1985. In 1987, lower revenues from traffic volume decreases were more than offset by expense savings from the traffic declines and the recovery of certain expenses from the Government of Canada. Higher interest expense was the principal factor in the 1986 worsening.

DISCONTINUED OPERATIONS

CN Hotels

CN Hotels, whose net assets are in the process of being sold, incurred a loss of $13.1 million in 1987 compared with losses of $6.3 million in 1986 and $8.1 million in 1985. The main factors in the 1987 worsening were abnormal losses relating to restaurant closures, inventory and receivable write-downs and the expensing of previously-deferred development and other costs, with some of these items being influenced by the impending divestiture. The 1986 improvement resulted primarily from the effects of restaurant closings in 1985 as well as from higher average room revenues and increased occupancies at Jasper Park Lodge and Hotel Vancouver due to Expo 86, the world's fair in Vancouver.

CN Route

In 1986 a loss of $71.0 million was attributed to CN Route, which was sold late in the year. This compared to a loss of $42.6 million in 1985. A $25.7 million loss on ten months of operations, an $18.4 million loss on disposal and shut-down costs of $26.9 million accounted for the 1986 loss.

Dockyard

The Dockyard, which was sold in 1987, reported 1987 income of $6.3 million compared with losses of $9.4 million in 1986 and $2.9 million in 1985. The 1987 income was due to the sale of the assets and income realized from an operating agreement concerning the Dockyard. The 1986 results included a $4.9 million write-down of the value of assets in anticipation of disposal.

INCOME TAXES

Total income taxes for 1987 have been reduced by the amount of $56.4 million through utilization of tax benefits pertaining to prior years' losses, which reduction was accounted for as an extraordinary item. There were no income taxes payable in 1986 because of the System loss. The corresponding amount for 1985 was $57.4 million. See Note 12 of Notes to Consolidated Financial Statements which indicates that such benefits are available to reduce taxable income of future years.

LIQUIDITY AND CAPITAL RESOURCES

In 1987, internally-generated funds were sufficient for net capital spending requirements, the retirement of maturing debt and a reduction of $43.6 million in short-term bank indebtedness. New long-term debt incurred of $19.0 million was largely for assets acquired under capital leases.

Short-term bank loans are used to finance cash deficiencies. At December 31, 1987, such loans totalled Canadian $67.0 million. The Company has arrangements with a number of Canadian and U.S. banks which provide lines of credit in excess of the Company's anticipated short-term borrowing requirements.

The main debt repayments by the Company in 1987 were a $45.9 million 8-7/8% Eurobond issue, a $93.6 million 5% Canadian bond issue and a 100 million Swiss Franc 5-1/8% note issue.

As a consequence of the debt reduction during the year and the net income for the year, the Company's year-end debt ratio decreased from 52.8% to 48.6%.

Planned capital expenditures for 1988 are approximately $490 million. In addition, the Company anticipates that capital expenditures for 1989 and 1990 will aggregate approximately $1.0 billion. The capital expenditure program for 1988 to 1992 includes funds required for renewal of basic plant, purchase of rolling stock and other equipment and improvement of operating efficiency. The Company expects that although the major portion of these expenditures will be funded internally, the aggregate of capital expenditures, together with provision for existing debt maturities, may require further borrowings.

At December 31, 1987, the Company had commitments to purchase railway ties at an aggregate cost of $21.6 million and rail of $9.7 million.

INFLATION

The Company's 1987 inflation rate for wage, fuel and material costs was around 1.5% compared with an estimated 4.4% increase in the Canadian Consumer Price Index. The corresponding figures for 1986 were about 0.5% and 4.2% respectively and for 1985, about 5% and 4%.

The main reason for the Company's low rate of inflation in 1987 was the stabilization of material prices. In fact, the overall railway material price index fell some 0.3% below the 1986 level.

In 1986, the main reason for the Company's low level of inflation was the drop in the price of diesel and other fuels. Excluding fuel, the Company's overall inflation rate rose by approximately 3%.

In 1985, an increase in fuel prices, due to higher applicable excise tax, was the main factor causing the Company's inflation rate to exceed the change in consumer prices.

CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 1987

CONSOLIDATED STATEMENT OF INCOME

Year ended December 31		1987	1986	1985
(in thousands)				
CN Rail	Revenues	$3,716,385	$3,652,655	$3,753,190
	Expenses*	3,605,010	3,663,826	3,647,658
	Income (loss)	111,375	(11,171)	105,532
Grand Trunk Corporation	Revenues	486,044	531,399	551,782
	Expenses	464,197	545,556	538,200
	Income (loss)	21,847	(14,157)	13,582
Enterprises group:				
CN Communications	Revenues	296,517	299,744	303,930
	Expenses	275,122	263,505	260,882
	Income	21,395	36,239	43,048
CN Exploration	Revenues	37,293	33,869	56,730
	Expenses	26,672	29,368	26,123
	Income	10,621	4,501	30,607
CN Real Estate	Revenues	54,102	35,157	29,582
	Expenses	16,300	16,330	14,885
	Income	37,802	18,827	14,697
Other	Income	7,548	7,487	4,215
Total Enterprises group		77,366	67,054	92,567
Total CN Rail, Grand Trunk Corporation, Enterprises		210,588	41,726	211,681
Imposed public duty: TerraTransport	Loss	(38,964)	(41,291)	(39,908)
Total continuing operations		171,624	435	171,773
Discontinued operations:*				
CN Hotels	Loss	(13,113)	(6,324)	(8,147)
CN Route	Loss	–	(70,961)	(42,590)
Dockyard	Income (loss)	6,268	(9,430)	(2,933)
Total discontinued operations		(6,845)	(86,715)	(53,670)
Income (loss) before income taxes and extraordinary items		164,779	(86,280)	118,103
Income taxes		57,486	–	57,823
Income (loss) before extraordinary items		107,293	(86,280)	60,280
Extraordinary items**		13,289	–	57,359
Net income (loss)		$ 120,582	$ (86,280)	$ 117,639

* See Note 2.

** See Note 3.

See accompanying notes to consolidated financial statements.

CONSOLIDATED BALANCE SHEET

December 31			1987		1986
(in thousands)					
Assets					
Current	Accounts receivable		$ 451,322		$ 494,597
	Material and supplies		284,850		377,132
	Other		229,613		252,915
			965,785		1,124,644
Insurance Fund			10,598		8,905
Investments			170,859		75,270
Properties			6,212,562		6,248,505
Other Assets and Deferred Charges			233,845		385,290
			$7,593,649		$7,842,614
Liabilities					
Current	Bank indebtedness		$ 63,260		$ 106,894
	Accounts payable and accrued charges		942,250		899,189
	Current portion of long-term debt		208,649		305,812
	Other		237,027		186,273
			1,451,186		1,498,168
Provision for Insurance			10,598		8,905
Other Liabilities and Deferred Credits			298,110		274,097
Long-Term Debt			2,728,331		3,052,486
Minority Interest in Subsidiary Companies			4,345		4,345
Shareholder's Equity	Capital Stock	$2,278,867		$2,278,867	
	Retained Earnings	822,212	3,101,079	725,746	3,004,613
			$7,593,649		$7,842,614

See accompanying notes to consolidated financial statements.

On behalf of the board:
Brian O'N. Gallery, Director
Ronald E. Lawless, Director

CONSOLIDATED STATEMENT OF RETAINED EARNINGS

Year ended December 31	1987	1986	1985
(in thousands)			
Balance, beginning of year	$ 725,746	$ 812,026	$ 717,915
Net income (loss)	120,582	(86,280)	117,639
	846,328	725,746	835,554
Dividend	24,116	–	23,528
Balance, end of year	$ 822,212	$ 725,746	$ 812,026

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

Year ended December 31	1987	1986	1985
(in thousands)			
Cash provided from (used for):			
Operating activities:			
Net income (loss)	$ 120,582	$ (86,280)	$ 117,639
Non-cash charges to income:			
Depreciation and amortization	293,045	311,807	282,817
Loss (income) of equity investees less dividends	1,473	1,055	308
Provision for property impairment*	43,075	–	–
Loss on disposal of investment	–	–	737
Loss on disposal of CN Route	–	45,320	–
Changes in working capital items**	252,674	(21,194)	(73,273)
Other	33,584	9,928	(23,600)
	744,433	260,636	304,628
Investing activities:			
Additions to properties	(482,058)	(484,072)	(744,475)
Net proceeds from disposal of properties	67,590	48,094	39,670
Investments	(6,723)	(5,202)	(23,010)
Proceeds from sale of CN Marine Inc. and related assets	–	327,558	–
Redemption of capital stock	–	(327,558)	–
Proceeds from sale of CN Route	–	23,000	–
Proceeds from sale of Newfoundland Dockyard	23,596	–	–
Proceeds from sale of investment	–	–	1,571
Working capital of previously consolidated entities	(2,747)	(7,633)	–
	(400,342)	(425,813)	(726,244)
Cash provided (used) before financing activities	344,091	(165,177)	(421,616)
Cash (bank indebtedness) beginning of year	(106,894)	(152,719)	(91,687)
	237,197	(317,896)	(513,303)
Financing activities:			
Issuance of long-term debt	19,020	435,492	597,060
Reduction of long-term debt	(319,477)	(224,490)	(236,476)
	(300,457)	211,002	360,584
Bank indebtedness, end of year	$ (63,260)	$ (106,894)	$ (152,719)

* See Note 3.

** Excluding cash, bank indebtedness, and current portion of long-term debt

See accompanying notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Introduction
All references in these Notes to the "Company" refer to Canadian National Railway Company which is wholly owned by the Government of Canada and, unless the context otherwise requires, its consolidated subsidiaries, and all references to the "System" mean Canadian National Railway Company and its consolidated subsidiaries together with the lines of railway, telecommunications and other property entrusted by the Government of Canada to the Company for management and operation. A division designated in the Consolidated Statement of Income as an "Imposed public duty", as is TerraTransport, is one whose operations are continued by the Company in accordance with directions from the Government of Canada despite the fact that such continued operations are contrary to the economic interests of the Company.

a) Principles of Consolidation
The consolidated financial statements include the accounts of all significant subsidiaries and the Company's share of the assets, liabilities, revenues and expenses of CNCP Telecommunications which is accounted for by the proportionate consolidation method; CN's share in the activities of CNCP Telecommunications represents slightly more than half of the activities of CN Communications. Also, consistent with the legislation governing the System, the accounts of the Canadian Government Railways entrusted to the Company by the Government of Canada are included in the consolidated financial statements.

Once a formal plan for the disposition of a significant segment has been adopted, the segment is no longer consolidated but reported under the equity method and included in "Investments" in the consolidated financial statements. The related operating results are reported as results of discontinued operations.

Investments in entities in which the Company has less than a majority interest are accounted for by the equity method, where appropriate.

b) Reporting by Division
In presenting the results by division, interdivisional charges for services have not been eliminated. Consolidated net income is not affected by this practice.

c) Material and Supplies
The inventory is valued at laid down cost based on weighted average cost for ties and rails, latest invoice price for fuel and new materials in stores, and at estimated utility or sales value for usable second hand, obsolete and scrap materials.

d) Insurance Fund
Certain System components are self-insured for various risks, with a separately-invested fund being maintained. The provision for insurance represents the estimated amount of self-insured losses to be settled.

e) Properties
Accounting for railway and telecommunications properties is carried out in accordance with rules issued by the Canadian Transport Commission and the Canadian Radio-television and Telecommunications Commission respectively (Canadian properties), and the Interstate Commerce Commission (United States properties). Generally, major additions and replacements are capitalized and interest costs are charged to expense.

The cost of depreciable railway and telecommunications assets retired or disposed of, less salvage, is charged to accumulated depreciation, in accordance with the group plan of depreciation. Other depreciable assets retired or disposed of are accounted for in accordance with the unit plan whereby gains or losses are taken into income as they occur.

The Company follows the successful efforts method of accounting for its oil and gas operations whereby the acquisition costs of oil and gas properties, the costs of successful exploratory wells and the costs of drilling and equipping development wells are capitalized.

f) Depreciation
Depreciation is calculated at rates sufficient to write off properties over their estimated useful lives, generally on a straight-line basis. For railway and telecommunications properties, rates are authorized by the Canadian Transport Commission, the Canadian Radio-television and Telecommunications Commission and the Interstate Commerce Commission. The rates for significant classes of assets are as follows:

	Annual Rate
Ties	2.46%-2.89%
Rails	1.87%
Other track material	2.23%-2.83%
Ballast	2.76%
Road locomotives	5.23%
Freight cars	1.73%-3.18%
Commercial communication systems	5.78%

Acquisition costs of oil and gas properties are amortized on a straight-line basis over the term of the lease until such time as the properties are determined to be productive or judged to be impaired. Acquisition costs of productive properties and costs of successful exploratory drilling and of drilling and equipping development wells are charged against income on the unit-of-production method based upon proven reserves of oil and gas. Exploratory dry hole and acquisition costs judged to be impaired are charged against income in the current period. Other exploratory expenditures are charged against income as incurred.

g) Transporation Revenues
Transportation revenues are generally recognized on completion of movements, with interline movements being treated as complete when the shipment is turned over to the connecting carrier. Costs associated with movements not completed are generally deferred.

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Cont'd.)

h) Pensions
Pension costs are determined periodically by independent actuaries. Pension expense is charged annually to operations and comprises the total of the following:
- the cost of pension benefits provided in exchange for employees' services rendered during the year, and
- amortization of past service costs over the expected average remaining service life of the employee group covered by the plans.

The pension plans are funded through contributions determined in accordance with the accrued benefit actuarial cost method.

i) Foreign Exchange
The Company's foreign operations are classified as integrated and are translated and accounted for on the following bases. Current assets (excluding material and supplies), current liabilities and long-term debt are translated at the rates in effect at the balance sheet date, whereas all other assets and liabilities are translated at historical rates. Revenues and expenses are translated at average rates during the year except for depreciation which is translated at exchange rates prevailing when the related properties were acquired.

The Company's own foreign denominated assets and liabilities are accorded similar treatment. Revenues and expenses are translated at rates prevailing at the time of the transactions except for revenues designated as a hedge against repayment of foreign denominated long-term debt which are translated at the rate in effect at the inception of the debt.

Currency gains and losses are reflected in net income for the year, except for unrealized foreign currency losses on long-term debt. The Company has designated future U.S. dollar revenue streams as a hedge against the repayment of most of its long-term debt denominated in U.S. dollars, and has thus deferred reflecting the related unrealized foreign currency translation losses in net income until the earlier of the debt repayment or the expiry of the hedge. Unrealized foreign currency losses related to long-term debt denominated in U.S. dollars not covered by the hedge are deferred and amortized over the remaining life of the debt. Such deferred amounts are included in the Consolidated Balance Sheet as part of Other Assets and Deferred Charges.

j) Leases
Leases which satisfy the criteria for capital leases and which have been entered into after 1981 have been capitalized. Other leases entered into prior to 1982, satisfying the criteria for capital leases, have been recorded as operating leases.

NOTE 2: DISCONTINUED OPERATIONS AND SPECIAL CHARGE

a) Discontinued Operations
During 1987 the Company entered into negotiation for the sale of its CN Hotels division and disposed of its former dockyard operations in Newfoundland. Details of the losses (income) incurred on these and other operations discontinued within the three years ended December 31, 1987 are as follows:

Year ended December 31	1987	1986	1985
(in thousands)			
CN Hotels (see Note 16)			
Operating loss	$13,113	$ 6,324	$ 8,147
CN Route			
Operating loss	–	25,641	42,590
Loss arising from disposal	–	45,320	–
	–	70,961	42,590
Dockyard			
Operating (income) loss	(6,268)	4,530	2,933
Provision for loss arising from disposal	–	4,900	–
	(6,268)	9,430	2,933
Total Discontinued operations	$ 6,845	$86,715	$53,670

b) Special Charge
CN Rail expenses include a special charge of $6.0 million (1986 – $60.2 million, 1985 – $40.4 million) relating to a provision for rationalization costs in connection with an ongoing program to reduce the size of the CN Rail work force.

NOTE 3: EXTRAORDINARY ITEMS

Year ended December 31	1987	1986	1985
(in thousands)			
Reduction in income taxes on application of prior years' losses	$56,364	$ –	$57,359
Less provision to write down the non-monetary assets of TerraTransport to a nominal value in view of their continuing inability to generate net income	43,075	–	–
	$13,289	$ –	$57,359

NOTE 4: INVESTMENTS

December 31		1987	1986
(in thousands)			
	Percentage of Voting interest		
Entities accounted for by equity method:			
CNCP Niagara-Detroit Partnership	50%	$ 14,757	$17,834
The Toronto Terminals Railway Company	50%	10,682	10,682
CN Hotels (see Notes 2 a) and 16)		120,025	–
Dockyard (see Note 2 a))		–	26,417
Other		13,791	11,253
		159,255	66,186
Other companies and investments, at cost less provisions for impairment where applicable		11,604	9,084
Total		$170,859	$75,270

NOTE 5: PROPERTIES

	December 31, 1987			December 31, 1986		
	Cost	Accumulated Depreciation	Net	Cost	Accumulated Depreciation	Net
(in thousands)						
CN Rail	$8,150,866	$2,953,747	$5,197,119	$7,978,729	$2,869,139	$5,109,590
Grand Trunk Corporation	531,609	142,715	388,894	557,864	153,150	404,714
Enterprises group:						
CN Communications	761,979	312,858	449,121	742,175	312,045	430,130
CN Exploration	94,480	35,627	58,853	85,728	25,261	60,467
CN Real Estate	78,881	16,204	62,677	63,279	13,861	49,418
Other	71,513	15,615	55,898	71,353	14,354	56,999
TerraTransport (see Note 3)	–	–	–	89,919	56,429	33,490
Discontinued operations:						
CN Hotels	–	–	–	164,894	61,197	103,697
	$9,689,328	$3,476,766	$6,212,562	$9,753,941	$3,505,436	$6,248,505
Amounts included above with respect to Canadian Government Railways entrusted to the Company by the Government of Canada	$1,073,992	$ 564,974	$ 509,018	$1,060,097	$ 569,633	$ 490,464

At December 31, 1987 the gross value of assets under capital leases included above was $132.5 million (1986 – $119.4 million) and related accumulated amortization thereon amounted to $14.1 million (1986 – $9.3 million).

OTE 6:

LONG-TERM DEBT

December 31 (in thousands)	Maturity	Currency in which Payable	1987	1986
Bonds, Debentures and Notes				
Canadian National 8-7/8% 10 Year Bonds (b)	Mar. 1, 1987	Canadian	$ –	$ 45,947
Canadian National 5% 27 Year Bonds (a, b)	Oct. 1, 1987	Canadian	–	93,596
Canadian National 14-5/8% 10 Year Notes (c)	Dec. 1, 1991	United States	117,817	117,817
Canadian National 11-3/8% 8 Year Notes	June 11, 1993	Canadian	100,000	100,000
Canadian National 9-7/8% 8 Year Notes	Mar. 18, 1994	Canadian	100,000	100,000
Canadian National 12-1/2% 10 Year Notes	Apr. 15, 1995	Canadian	100,000	100,000
Canadian National 6-1/2% 10 Year Japanese Yen Notes (d)	Mar. 26, 1996	Canadian	70,000	70,000
Canadian National 9-3/8% 10 Year Notes	Oct. 1, 1996	Canadian	100,000	100,000
Canadian National 9-1/4% 20 Year Sinking Fund Debentures	Mar. 15, 1998	United States	89,022	106,826
Canadian National 5-3/8% 15 Year Swiss Franc Bonds (e)	Aug. 22, 2000	Canadian	98,617	98,617
Canadian National 8-7/8% 15 Year Notes	May 21, 2001	Canadian	150,000	150,000
Canadian National 8-3/8% 25 Year Sinking Fund Debentures	July 1, 2002	United States	75,124	84,748
Canadian National 9.70% 25 Year Sinking Fund Debentures	July 15, 2004	United States	174,940	174,940
Canadian National 13% 20 Year Sinking Fund Debentures	Nov. 15, 2004	Canadian	96,732	100,000
Canadian National 12-1/4% 20 Year Sinking Fund Debentures	May 1, 2005	Canadian	125,000	125,000
Canadian National 14% 25 Year Sinking Fund Debentures	Jan. 15, 2006	United States	178,783	178,783
Canadian National 15% 25 Year Sinking Fund Debentures	June 1, 2006	United States	181,238	181,238
Canadian National 16-1/4% 25 Year Sinking Fund Debentures	Mar. 1, 2007	United States	183,053	183,053
Canadian National 14-3/4% 30 Year Sinking Fund Debentures	Sept. 1, 2012	United States	247,984	247,984
Canadian National 12% 30 Year Sinking Fund Debentures	Mar. 15, 2013	United States	122,548	122,548
Buffalo and Lake Huron 5-1/2% 1st Mortgage Bonds	Perpetual	Sterling	795	795
Buffalo and Lake Huron 5-1/2% 2nd Mortgage Bonds	Perpetual	Sterling	1,228	1,228
Total Bonds, Debentures and Notes			2,312,881	2,483,120
Government of Canada Loan and Advances (f)				
Government of Canada loan		Canadian	184,765	195,169
Canadian Government Railways advances for working capital		Canadian	–	13,918
Total Government of Canada Loan and Advances			184,765	209,087
Other				
Amounts owing under equipment purchase agreements (g)		United States	137,916	162,736
Swiss borrowings		Swiss Francs	–	64,684
Syndicated loan (h)		Canadian	42,610	42,610
Capital lease obligations (i)		Various	119,037	108,895
Term loan (j)		United States	2,634	–
Promissory note 9-5/8%		Canadian	–	778
Income debenture		Canadian	–	8,065
Adjustment to current exchange rate (see Note 1 i))			143,861	285,794
Total Other			446,058	673,562
			2,943,704	3,365,769
Less: Current portion of long-term debt			208,649	305,812
Unamortized discount and other			6,724	7,471
			215,373	313,283
Long-Term Debt			$2,728,331	$3,052,486

a) Guaranteed by the Government of Canada.
b) These bonds are subject to repurchase arrangements.
c) It is the Company's intention, given continuing favourable interest rates, to redeem this issue on its "call" date of December 1, 1988. The amount of the issue is accordingly included in the current portion of long-term debt.
d) The Company borrowed $70.0 million at an all-in cost of 10.25% by means of a Euro-yen public note issue and a currency swap.
e) The Company borrowed $98.6 million at an all-inclusive cost of 11.17% by means of a public bond issue in Switzerland and a currency swap.
f) The Government of Canada loan bears interest at 8-3/4% per annum and is payable in equal semi-annual payments of $13.63 million covering principal and interest to June 30, 1998.
g) Secured by rolling stock and payable by semi-annual or quarterly instalments over various periods to 1995 at interest rates ranging from 8% to 17-3/4%. As at December 31, 1987, the principal amounts are payable as U.S. $121.1 million (December 31, 1986 – U.S. $144.4 million).

NOTE 6: LONG-TERM DEBT (Cont'd.)

h) The Company borrowed $42.6 million at an all-inclusive cost of 11.535% by means of a yen syndicated loan and currency swap.
i) Interest rates for these leases range from approximately 7-7/8% to 14-1/2% with expiry dates occurring during the years 1988 through 2004. The imputed interest on these leases amounts to $107.0 million (1986 – $116.2 million).
j) Repayable by annual principal instalments of $400,000 over a five year term, to August 15, 1992. The interest is charged at favourable varying rates.
k) Principal repayments, including sinking fund repayments, repurchase arrangements and capital lease repayments, on debt outstanding at December 31, 1987, are as follows:

Year ending December 31:	(in thousands)
1988	$ 208,649
1989	74,127
1990	76,910
1991	101,197
1992	111,776
1993-1997	1,115,606
1998-2002	740,149
2003-2007	391,668
2008-2012	101,995
2013	12,993

NOTE 7: SHAREHOLDER'S EQUITY

a) Capital Stock
The capital stock of Canadian National Railway Company, $2,278,866,774, consists of 5,868,786 common shares of no par value authorized, issued and outstanding which are owned by the Government of Canada.

b) Retained Earnings
Under its governing legislation, the Company is required to pay to the Receiver General for Canada a dividend equal to 20% of net income for the year or such greater percentage as the Governor in Council may direct. Accordingly, a dividend representing 20% of the net income for the year, has been accrued and is included in Other Current Liabilities. The dividend accrued on 1985 income which has not yet been paid is also included in that caption.

NOTE 8: MAJOR COMMITMENTS

a) Leases
(i) The Company's commitments as at December 31, 1987, under leases, excluding those which have been capitalized and for which the lease obligations are recorded as long-term debt (see Note 6), are as follows:

Non-Cancellable Leases	Pre-1982 Capital Leases	Operating Leases
(in thousands)		
Year ending December 31:		
1988	$ 37,802	$ 89,765
1989	31,838	81,755
1990	13,118	53,657
1991	5,904	47,502
1992	4,393	44,683
1993-1997	6,611	168,221
1998-2002	2,927	29,626
thereafter	447	4,622
Total minimum lease payments	103,040	$519,831
Less amount representing imputed interest	17,858	
Present value of net minimum lease payments under capital leases	$ 85,182	

A significant portion of the leases is in respect of railway rolling stock and many of them provide renewal options and an option to purchase the property at fair market value at the end of the lease term.

NOTE 8: **MAJOR COMMITMENTS (Cont'd.)**

a) Leases (Cont'd.)
(ii) Rental expenses under all lease arrangements which have not been capitalized were:

Year ended December 31	1987	1986	1985
(in thousands)			
Total expenses	$173,298	$178,034	$187,949
Expenses under pre-1982 capital leases included in total expenses	$ 43,188	$ 46,825	$ 50,863

(iii) Increases in income, assets and liabilities in the consolidated financial statements, which would have arisen if leases entered into prior to 1982 and which satisfied the criteria for capital leases had been capitalized, are as follows:

Year ended December 31	1987	1986	1985
(in thousands)			
Net increase in income	$ 13,132	$ 11,609	$ 10,776
Increase in Assets			
Properties			
Leased properties under capital leases	$174,101	$194,092	$238,429
Less accumulated amortization	127,481	128,565	156,672
	46,620	65,527	81,757
Other assets and deferred charges			
Unamortized deferred exchange loss	10,172	17,508	23,990
	$ 56,792	$ 83,035	$105,747
Increase in Current Liabilities			
Present value of obligations under capital leases	$ 30,900	$ 33,935	$ 33,387
Increase in Non-Current Liabilities			
Present value of obligations under capital leases	$ 73,726	$101,622	$127,180
Adjustment to current exchange rate (see Note 1 i))	11,456	22,324	30,699
	85,182	123,946	157,879
Less current portion	30,900	33,935	33,387
	$ 54,282	$ 90,011	$124,492

b) Other
The Company has commitments at December 31, 1987, for capital expenditures of $21.6 million for railway ties and $9.7 million for rail.

NOTE 9: **SUBSIDIES**

Revenues include the following subsidies:

Year ended December 31	1987	1986	1985
(in thousands)			
Government of Canada			
a) Payments under the Railway Act paid under authority of that Act and the related Appropriation Act in respect of certain uneconomic operations, services and prescribed rates which railways are required by the Railway Act to maintain	$37,661	$39,641	$37,151
b) Maritime Freight Rates Act and Atlantic Region Freight Assistance Act subsidies	18,520	18,735	20,460
c) Sundry	1,884	2,502	6,074
Other assistance	134	163	167
	$58,199	$61,041	$63,852

NOTE 10: PENSIONS

The Company has retirement benefit plans covering substantially all its employees under which they are entitled to benefits at retirement age generally based on compensation and length of service and/or contributions.

Effective January 1, 1987, the Company implemented prospectively the new recommendations of the Canadian Institute of Chartered Accountants using actuarial valuations as at December 31, 1986 for all significant pension plans. These December 31, 1986 valuations revealed a consolidated actuarial liability of $6.2 billion and a consolidated actuarial asset value of $4.9 billion. For purposes of the new CICA recommendations, it is estimated that those amounts could approximate $6.3 billion and $5.3 billion respectively as at December 31, 1987. Subsequent actuarial valuations will determine the actual values at that date.

Annual pension costs were:

Year ended December 31	1987	1986	1985
(in thousands)			
	$200,731	$194,425	$139,956

NOTE 11: SYSTEM INTEREST EXPENSE

Year ended December 31	1987	1986	1985
(in thousands)			
Interest			
Total interest on long-term debt	$367,142	$380,977	$333,574
Interest on short-term borrowings	7,175	6,889	5,381
Interest income	(2,435)	(5,567)	(2,713)
	$371,882	$382,299	$336,242

NOTE 12: INCOME TAXES

a) The Company has timing differences of approximately $390 million which are available to reduce taxable income of future years. Of that amount, about $119 million is due to the excess of the undepreciated capital cost for income tax purposes over net book value of depreciable assets.

b) Investment tax credits are also available to reduce future income taxes otherwise payable until the related year of expiry:

Year of Expiry	(in millions)
1988	$ 4.3
1993	$25.9
1994	$33.9
1995	$29.7
1996	$18.9
1997	$12.7

The Company is eligible for a refund of 20% of the current year's investment tax credits in respect of qualified expenditures and has recognized the resulting benefit as a reduction of such expenditures.

c) The Company's provision for income taxes is made up as follows:

Year ended December 31	1987	1986	1985
(in thousands)			
Provision for (recovery of) income taxes based on combined basic Canadian federal and provincial tax rate of 48.6% (1986 – 49.8%, 1985 – 48.9%)	$59,148	$(42,967)	$57,752
Increase (decrease) in taxes resulting from:			
Non-taxable portion of capital gain on disposals of discontinued operations	–	(21,631)	–
Non-allowable foreign exchange loss on conditional sale agreements	1,347	1,535	437
Profit on sale of land	(6,785)	(2,528)	(2,874)
Unapplied losses	–	62,256	–
Other	3,776	3,335	2,508
Actual provision for income taxes resulting in an effective tax rate of 47.2% (1986 – Nil, 1985 – 49.0%)	$57,486	$ –	$57,823

NOTE 13: SEGMENTED INFORMATION

a) Geographic Areas
Virtually all of the System's operations and assets are within Canada with the exception of Grand Trunk Corporation which operates in the United States.

b) International Traffic
In addition to the revenue generated by Grand Trunk Corporation, the System derives revenue from traffic originating or terminating on railroads in the United States. In 1987, such revenues approximated $612 million (1986 – $587 million, 1985 – $628 million).

c) Revenues by Division

December 31	1987	1986	1985
(in thousands)			
CN Rail	$3,716,385	$3,652,655	$3,753,190
Grand Trunk Corporation	486,044	531,399	551,782
Enterprises group:			
CN Communications	296,517	299,744	303,930
CN Exploration	37,293	33,869	56,730
CN Real Estate	54,102	35,157	29,582
Other	38,608	38,130	29,439
TerraTransport	20,170	25,002	25,919
Discontinued operations:			
CN Hotels	135,010	126,131	111,631
CN Route	–	123,643	144,681
Dockyard	–	8,786	10,906
	$4,784,129	$4,874,516	$5,017,790

d) Identifiable Assets by Division

December 31	1987	1986	1985
(in thousands)			
CN Rail	$6,203,938	$6,301,242	$6,496,422
Grand Trunk Corporation	623,715	630,428	633,296
Enterprises group:			
CN Communications	528,223	506,242	498,873
CN Exploration	67,157	68,583	73,401
CN Real Estate	93,603	79,253	81,982
Other	67,139	68,239	66,485
TerraTransport (see Note 3)	9,874	52,304	56,906
Discontinued operations:			
CN Hotels	–	136,323	118,367
CN Route	–	–	76,493
Dockyard	–	–	36,556
	$7,593,649	$7,842,614	$8,138,781

NOTE 13: **SEGMENTED INFORMATION (Cont'd.)**

e) Capital Expenditures and Depreciation by Division

	Capital Expenditure*			Depreciation		
Year ended December 31	1987	1986	1985	1987	1986	1985
(in thousands)						
CN Rail	$355,146	$356,746	$594,303	$211,045	$212,305	$196,297
Grand Trunk Corporation	12,554	21,990	20,903	14,473	18,773	13,593
Enterprises group:						
CN Communications	68,094	58,152	64,658	45,585	47,492	46,192
CN Exploration	9,147	10,859	33,283	10,723	13,093	6,994
CN Real Estate	17,981	13,720	5,687	1,027	815	1,026
Other	340	341	279	1,437	1,453	1,440
TerraTransport	589	5	3,037	2,461	5,964	5,443
Discontinued operations:						
CN Hotels	18,207	22,393	20,296	6,023	5,278	4,783
CN Route	–	–	925	–	5,174	5,490
Dockyard	–	(134)	1,104	–	1,004	1,061
	$482,058	$484,072	$744,475	$292,774	$311,351	$282,319

*Represents additions to properties.

NOTE 14: **OTHER MATTERS**

a) The Company carries on ordinary business transactions with various entities controlled by the Government of Canada on the same terms and conditions as current transactions with unrelated parties.

In addition, the Company provides, under contractual arrangements, rail transportation and maintenance services to the Government of Canada and to entities controlled by the latter. The revenue derived from such services rendered in 1987 aggregated $148.2 million (1986 – $203.0 million, 1985 – $320.0 million).

b) Following enactment of the Western Grain Transportation Act, which became effective on January 1, 1984, the Government of Canada, in order to minimize the cost to grain shippers, pays a portion of the cost of shipping grain. Amounts received from the Government of Canada under the Western Grain Transportation Act amounted to $435.3 million in 1987 (1986 – $378.0 million, 1985 – $278.9 million), a reflection of the volume of grain handled.

c) Commencing in 1977, the Government of Canada has agreed to pay to the Company, by way of capital grants not exceeding $557.9 million, certain amounts with respect to expenditures incurred in carrying out rehabilitation programs for branch lines in Western Canada. Total payments received up to December 31, 1987, amounted to $457.0 million of which $25.6 million was received in 1987 (1986 – $34.5 million, 1985 – $43.7 million).

d) As part of a funding plan for the period from 1986 to 1990 for certain railway operating improvements in Newfoundland, the Company received $12.1 million from the Government of Canada in 1987 out of an expected $29.1 million to be received over the four-year period. As part of an earlier program for the testing and evaluation of such railway operations, billings to the Government of Canada amounted to $5.3 million in 1986.

NOTE 15: **RECLASSIFICATION OF COMPARATIVE FIGURES**

During 1987, changes were made to improve the classification of certain items and for comparative purposes the 1986 and 1985 figures have been reclassified.

NOTE 16: **SUBSEQUENT EVENT**

On January 29, 1988, the Board of Directors of the Company approved the sale of substantially all of the net assets of the CN Hotels Division for a consideration of $260 million plus working capital.

The net assets have been deconsolidated and are included in "Investments" in the consolidated financial statements (see Note 4).

AUDITORS' REPORT

Touche Ross

1, Place Ville Marie
Montreal, Quebec H3B 2A2

Coopers & Lybrand

La Windsor
1170 Peel Street
Montreal, Quebec, Canada
H3B 4T2

To The Minister of Transport
Ottawa, Canada

We have examined the consolidated balance sheets of the Canadian National Railway System as at December 31, 1987 and 1986 and the consolidated statements of income, retained earnings and changes in financial position for each of the years in the three year period ended December 31, 1987. Our examinations were made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the System as at December 31, 1987 and 1986 and the results of its operations and the changes in its financial position for each of the years in the three year period ended December 31, 1987 in accordance with generally accepted accounting principles applied on a consistent basis.

Touche Ross

Chartered Accountants
(For the years ended
December 31, 1987, 1986 and 1985)

Montreal, Quebec
March 8, 1988

Coopers & Lybrand

Chartered Accountants
(For the years ended
December 31, 1986 and 1985)

Montreal, Quebec
March 8, 1988

The Report of a Parliamentary Committee on Canadian National Railways' Pension System had an important influence on several actions taken by the Company. In response to that report Canadian National Railway Company undertook a four-year commitment to increase pension benefits. This longer term commitment of about $40 million for each of the four years will assist pensioners in coping with inflation. The new Pension Benefits Standards Act which came into effect January 1, 1987 was another source of improvement in the Pension area and resulted in an additional actuarial liability of $40 million as well as an increase in the current service cost to the Company. In addition, the Company is carrying out an extensive communications program to enhance understanding of its plans and related benefits among pensioners and employees. Consistent with the objective of improving the communication the presentation of the consolidated financial statements of the Canadian National Railway Pension Trust Fund has been simplified.

CONSOLIDATED STATEMENT OF NET ASSETS

As at December 31	1987	1986
(in thousands)		
Investments		
Bonds – quoted market value 1987 – $2,287,134; 1986 – $2,160,649	$2,185,495	$1,907,434
Mortgages	207,876	229,917
Real estate	309,869	320,796
Oil and gas	129,546	121,631
Equities – quoted market value 1987 – $2,391,138; 1986 – $2,411,556	1,806,059	1,521,976
Short-term investments	548,380	462,250
	5,187,225	4,564,004
Cash	2,362	1,060
Accounts receivable – Canadian National Railways	6,876	7,207
Other net assets	19,734	90,416
	$5,216,197	$4,662,687

See accompanying notes to consolidated financial statements.

AUDITORS' REPORT

To The Minister of Transport,
Ottawa, Canada

We have examined the Consolidated Statement of Net Assets of the Canadian National Railways Pension Trust Fund as at December 31, 1987 and the Consolidated Statement of Changes in Net Assets for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the Canadian National Railways Pension Trust Fund as at December 31, 1987 and the results of its operations for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Also, in our opinion, proper books of account have been kept and the transactions that have come under our notice have been within the powers of the Trustee.

Mallette, Benoit, Boulanger, Rondeau & Associés

Mallette, Benoit, Boulanger, Rondeau & Associés
Chartered Accountants
Montreal, March 7, 1988

CONSOLIDATED STATEMENT OF CHANGES IN NET ASSETS

Year ended December 31	1987	1986
(in thousands)		
Net assets, beginning of year	$4,662,687	$4,191,962
Net investment income	746,005	617,040
Contributions by employees	79,402	87,538
Contributions by Company	199,903	210,904
Total additions	1,025,310	915,482
Pension benefits paid	378,806	346,944
Refunds	23,917	12,731
Transfers to other funds	69,077	85,082
Total deductions	471,800	444,757
Net increase	553,510	470,725
Net assets, end of year	$5,216,197	$4,662,687

On behalf of the board:
Brian O'N. Gallery, Director
Ronald E. Lawless, Director

ACTUARY'S REPORT

To the Trustee
Canadian National Railways Pension Trust Fund

We have conducted actuarial valuations of the 1935 and 1959 Pension Plans and of the Northern Alberta Railways Company Pension Plan as at December 31, 1986 in accordance with generally accepted actuarial principles and the recommendations of the Canadian Institute of Actuaries. These valuations have revealed a consolidated actuarial liability of approximately $6.2 billion, a consolidated unfunded actuarial liability of approximately $1.3 billion and required a consolidated Company contribution of $199.9 million for 1987. The next actuarial valuations will be conducted as at December 31, 1989 at the latest.

In my opinion, the data on which these valuations were based were sufficient and reliable and the assumptions used were adequate and appropriate for purposes of the valuations; and the methods employed in the valuations were consistent with sound actuarial principles.

Bernard Morency
Fellow of the Canadian Institute of Actuaries

William M. Mercer Limitée
Montreal, February 22, 1988

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

a) Principles of Consolidation
The consolidated financial statements include the accounts of the Canadian National Railways Pension Trust Fund and its wholly-owned companies and encompass the 1935 and 1959 Pension Plans and the Northern Alberta Railways Company Pension Plan. These plans under which benefits are generally based on compensation and length of service and/or contributions cover substantially all employees of the Canadian National Railway System.

b) Investment Valuation
(i) Bonds are carried at their amortized cost less deferred amounts arising from exchanges; these amounts are written off over the remaining life of the bonds sold;

(ii) Mortgages are carried at outstanding principal balances and are secured by real estate;

(iii) Real estate consists of land, buildings, and equities. Land is carried at the lower of cost and net realizable value less encumbrances, buildings at the lower of cost and net realizable value less encumbrances and accumulated depreciation calculated using the sinking fund method, and equities amounting to $147.0 million in 1987 (1986 – $147.0 million) at cost. The quoted market value of these real estate equities was $167.3 million as at December 31, 1987 (December 31, 1986 – $158.5 million);

(iv) Oil and gas properties are carried at cost as determined by the full cost method less depletion;

(v) Equities and short-term investments are carried at cost;

(vi) The quoted market value of investments in bonds and equities is based on the closing market quotations as of December 31.

c) Determination of Contributions by the Company
In respect of the 1935, 1959 and the Northern Alberta Railways Company Pension Plans, the contributions by the Company are determined in accordance with the requirements of the Pension Benefits Standards Act (1985) and regulations thereunder and are based on the accrued benefit actuarial cost method using a projection of salary. Consistent with the regulations and in addition to the current service contribution, the Company is making quarterly special payments to liquidate the unfunded actuarial liability by 2006. Also, in the case of the 1935 Pension Plan, the Company makes contributions as determined by the rules of the plan.

In the latest actuarial valuations, the principal assumptions adopted by the Plans' actuary for purposes of the actuarial computations are members' mortality, disability, retirement, termination of employment, merit and periodic increases in earnings, as well as a long-term rate of return of 7.5% per annum on investments. Future increases in members' earnings have been projected using economic assumptions consistent with this long-term rate of return.

d) Accounting for Contributions
Contributions from employees are recorded in the period in which the Company makes payroll deductions. The contributions from the Company as determined by the latest actuarial valuations are recorded using the accrual method.

e) Income Determination
Dividend income is recorded as of the ex-dividend date. Income from other investments is recorded as earned on an accrual basis.

Gain or loss on sales of equities is based on the average cost.

f) Foreign Exchange
Investments denominated in foreign currencies other than short-term investments are translated at historical rates of exchange. Short-term investments and the quoted market value of investments denominated in foreign currencies are translated at current rates. Foreign dividends and interest income are translated at the rates prevailing when received.

NOTE 2: TRANSFERS TO OTHER FUNDS

During 1987, the Company has agreed to transfer approximately $69.1 million representing the value of the investments assigned to various outside parties as a result of transfers of CN employees to those parties.

NOTE 3: LATEST ACTUARIAL VALUATIONS

The latest actuarial valuations for the 1935, 1959 and the Northern Alberta Railways Company Pension Plans were as at December 31, 1986 and were submitted to the Superintendent of Financial Institutions. The consolidated actuarial liability and the consolidated unfunded actuarial liability resulting from these valuations amounted to approximately $6.2 billion and $1.3 billion respectively. Also, a market related method was used to value the assets for purposes of the actuarial valuations. This method resulted in a consolidated actuarial asset value which was adjusted to market by recognizing realized and unrealized gains over a period of five years using the straight line method. The consolidated actuarial asset value was approximately $4.9 billion as at the date of the latest actuarial valuations.

NOTE 4: OTHER MATTER

During 1987, some CN employees transferred to VIA Rail Canada Inc. (VIA). The value of the investments to be remitted to VIA has not yet been determined.